HINSHAW
& CULBERTSON LLP

Client Alert

January 30, 2014

SEC Proposes Rules to Increase Access to Capital for Smaller Companies

Section 401 of the JOBS Act directed the SEC to adopt rules to exempt the following class of securities from the provisions of the Securities Act of 1933 (the "1933 Act"):

- The aggregate offering amount of all securities offered and sold on a registration statement filed with the SEC within the prior 12-month period in reliance on this exemption must not exceed $50 million.
- The securities may be offered and sold publicly.
- The company may solicit interest in the offering prior to filing any offering statement with the SEC.
- The SEC will require the company to file audited financial statements with the SEC annually.

On December 18, 2013, the SEC proposed rules intended to implement Section 401. Comments are due on March 24, 2014. Set forth below is a brief overview of the proposed rules.

Regulation A

Regulation A is a longstanding, little used, exemption which allows companies to sell securities and avoid complying with the 1993 Act rules relating to the registration of securities offerings. Reg A permits unregistered public offerings of up to $5 million of securities in a 12-month period, including no more than $1.5 million of securities offered by security-holders of the company.

Currently, companies relying on Reg A must submit an offering statement to the SEC for review; the principal part of the statement is an offering circular which contains abbreviated disclosures. Reg A tailors those requirements for smaller companies. In addition, such offerings also are subject to state-level registration and qualification requirements. Most importantly, Reg A does not mandate ongoing reporting after the offering is completed

Reg A has been little used due to its limited offering size and disclosure burdens relative to other private placement exemptions, such as those offered by Regulation D.

Like current Reg A, securities issued under the proposed rule would not be subject to restrictions on transfer imposed by federal securities laws.

Proposal

The SEC's proposed rules would expand and revise Reg A and create two tiers of Reg A offerings:

- Tier 1 offerings would consist of those offerings already covered by Reg A – namely securities offerings of up to $5 million in a 12-month period, including up to $1.5 million for the account of selling security-holders.

- Tier 2 offerings would consist of securities offerings of up to $50 million in a 12-month period, including up to $15 million for the account of selling security-holders.

For offerings up to $5 million, a company could elect whether to proceed under Tier 1 or 2.

Unlike many private placement exemptions, Reg A does not set forth accreditation requirements or knowledge or sophistication requirements for either Tier 1 or Tier 2 investors. Therefore, the general public may invest.

Companies relying on Tier 2 of Reg A would be required to provide ongoing disclosure, as described below, but would not become subject to the reporting and most other requirements of the Securities Exchange Act of 1934 (the "1934 Act"). As a result, Reg A companies will not be subject to, among other rules, Sarbanes-Oxley, insider trading and reporting rules, or SEC proxy rules.

Eligible Securities

The Reg A exemption will only apply to equity securities, debt securities, and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities.

Eligibility

The revised Reg A would be available to companies organized in and with their principal place of business in the United States or Canada.

The Reg A exemption would not be available to companies that:

- Are already SEC reporting companies and certain investment companies.

- Have no specific business plan or purpose or have indicated their business plan is to engage in a merger or acquisition with an unidentified company.

- Are seeking to offer and sell asset-backed securities or fractional undivided interests in oil, gas, or other mineral rights.

- Have not filed the ongoing reports required by the proposed rules during the preceding two years.

- Are or have been subject to an SEC order revoking the company's registration under the 1934 Act during the preceding five years.

- Are disqualified under the proposed "bad actor" disqualification rules (see **"Bad Actor Disqualification Provisions"**, below).

Basic Requirements for Tier 1 and Tier 2

Whether relying on Tier 1 or Tier 2, a company would be subject to basic requirements, including ones addressing issuer eligibility and disclosure based on the existing provisions of Reg A. The regulation would also be updated to, among other things, permit:

- Companies to submit electronic draft offering statements for nonpublic SEC review prior to filing. If the offering proceeds, the drafts would have to be filed as an exhibit to the offering statement at least 21 days before qualification of the offering statement (see **"Qualification"**, below).

- Companies to "test the waters" or solicit interest in a potential offering with the general public either before or after the filing of the offering statement. This allows a company to determine if there is sufficient interest in the offering. The solicitation materials used after publicly filing the offering statement must precede or be accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained. This requirement could be satisfied by providing the URL where the preliminary offering circular or the offering statement may be obtained on EDGAR. Solicitation material would be submitted or filed as an exhibit when the offering statement is either submitted for non-public review or filed (and updated for substantive changes in such material after the initial non-public submission or filing) but would no longer be required to be submitted at or before the time of first use.

- Companies that sell to prospective purchasers in reliance on the delivery of a preliminary offering circular must, not later than two business days after completion of the sale, provide the purchasers with a copy of the final offering circular or a notice that the sale occurred pursuant to a qualified offering circular that includes the URL where the final offering circular or to the offering circular of which such final offering circular is part may be obtained and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and received in response.

- Companies to file offering circular supplements after qualification of the offering circular in certain circumstances in lieu of post-qualification amendments, including providing the types of information that may be excluded from a prospectus under Rule 430A.

- Continuous or delayed offerings. Companies involved in continuous or delayed Tier 2 offerings must be current in their annual and semiannual reporting obligations (on Forms 1-K and 1-SA, respectively, discussed below).

Additional Tier 2 Requirements

A Tier 2 offering would also be subject to the following requirements:

- An investor would be limited to purchasing no more than 10% of the greater of the investor's annual income or net worth. The annual income and net worth would be calculated for individuals as provided in the accredited investor definition in Reg D. The company would be allowed to rely on the representations of the purchasers of the securities that they are not exceeding the limit.

- The financial statements included in the offering circular would have to be audited in accordance with the rules of the PCAOB.

- Companies relying on Tier 2 would not have a class of securities registered under Section 13 or 15 of the 1934 Act, or be subject to the on-going reporting requirements of the 1934 Act. However, Reg A companies relying on the Tier 2 exemption would be required to file annual and semiannual ongoing reports and current event updates that are similar to the requirements for public companies. The annual report would be on a new Form 1-K; the semiannual report would be made on new Form 1-SA and the current event reports would be filed on Form 1-U. Form I-K would require disclosures relating to the company's business and operations for the preceding three years (or since inception, if in existence for less than three years); related party transactions; beneficial ownership; executive officers and directors; executive compensation; MD&A; and two years of audited financial statements. Form 1-SA and Form 1-U are analogous to Form 10-Q and Form 8-K, respectively, but with scaled disclosure requirements. These reports would be required to be filed via EDGAR: (i) Form 1-K-- 120 days after the fiscal year end; (ii) Form 1-SA--90 days after the end of the second fiscal quarter; and (iii) Form 1-U-- within four business days of the relevant event.

- A company conducting a Tier 2 offering would have to file a Form 1-U to report the following events:

    - fundamental changes in the business;

    - bankruptcy or receivership;

    - material modification to the rights of securityholders;

    - changes in the company's certifying accountant;

    - non-reliance on previous financial statements or a related audit report or completed interim review;

- changes in control of the company;
- departure of the principal executive officer, principal financial officer, or principal accounting officer; and
- unregistered sales of 5% or more of outstanding equity securities.

- Companies conducting Tier 2 offerings would exit the Reg A ongoing reporting regime when they become subject to the ongoing reporting requirements of Section 13 of the 1934 Act. They may also exit the this reporting regime at any time by filing a Form 1-Z exit report after completing reporting for the fiscal year in which the offering statement was qualified, so long as the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers or sales made in reliance on a qualified Reg A offering statement are not ongoing.

Qualification

Under current Reg A rules, an offering statement is generally only qualified by order of the SEC in a manner similar to a registration statement being declared effective. In such instances, the company includes a delaying notation on the cover of the Form 1-A that states the offering statement shall only be qualified by order of the SEC. In order to remove a delaying notation, a company must file an amendment to the offering statement indicating that the offering statement will become qualified on the 20th calendar day after filing. An offering statement that does not include a delaying notation will be qualified with SEC action on the 20th calendar day after filing.

Under the proposed rules, an offering statement could be qualified by order of the SEC and the process associated with the delaying notation would be eliminated.

Offering Statement

Under the proposed rules, companies would continue to file an offering statement on Form 1-A as revised. In addition, the proposed rules will:

- Require companies to electronically file with the SEC offering statements on revised Form 1-A.
- Eliminate the Model A (Question-and-Answer) disclosure format under Part II (Offering Circular) of Form 1-A.
- Update and clarify the Model B (Narrative) disclosure format under Part II of Form 1-A (renaming it as Offering Circular), while continuing to permit the use of Part I of Form S-1 narrative disclosure as an alternative.
- Require companies in a Tier 2 offering to include audited financial statements in their offering circulars. A company conducting a Tier 1 offering would be

required to include audited financials to the extent the company has prepared them for other purposes.

- Require all companies to file balance sheets for the two most recently completed fiscal year ends (or for such shorter time that they have been in existence).

- Permit companies to provide financial statements in Form 1-A that are dated not more than nine months before the date of non-public submission or filing, and require companies to include financial statements in Form 1-A that are dated not more than nine months before qualification, with the most recent annual or interim balance sheet not older than nine months. If interim financial statements are required, they must cover a period of at least six months.

Updated Model B will require various disclosures, requiring companies to provide information about:

- the company and the offering;

- material risks;

- material disparities between the public offering price and the effective cash costs for shares acquired by insiders during the past year;

- plan of distribution for the offering;

- use of proceeds;

- overview of the company's business, including description of material physical properties;

- management discussion and analysis;

- information about executive officers and directors including compensation;

- beneficial ownership information;

- related party transactions;

- description of the offered securities;

- financial statements for the preceding two years; and

- any events that would have triggered disqualification of the offering under the ''bad actor'' provision of the proposed rules, but occurred before the effective date of the proposed rules (see **"Bad Actor Disqualification Provisions"**, below).

Ongoing Reporting

The proposed rules will require:

- Companies that conduct a Tier 1 offering to electronically file a Form 1-Z exit report with the SEC not later than 30 calendar days after termination or completion of a qualified Reg A offering to provide information about sales in such offering and to update certain company information.

- Companies that conduct a Tier 2 offering to electronically file with the SEC annual and semiannual reports, as well as current event updates on Forms 1-K, 1-SA and 1-U, respectively (see "**Additional Tier 2 Requirements**", above for a discussion of these forms).

- Companies to, where applicable, provide special financial reports to provide information to investors in between the time the financial statements are included in Form 1-A and the company's first periodic report due after qualification of the offering statement.

- Companies that conduct a Tier 2 offering to include in their first annual report (on Form 1-K) after termination or completion of a qualified Reg A offering, or in their Form 1-Z exit report, information about sales in the terminated or completed offering and to update certain company information.

Secondary Trading

The proposed rules include provisions designed to facilitate the development of secondary trading markets for securities issued in connection with Tier 2 offerings. As proposed, brokers would be permitted to rely upon information contained in reports filed by Reg A companies to satisfy the broker's obligations under 1934 Act Rule 15c2-11. The SEC is considering whether Reg A reports may serve as the basis for satisfying the information requirements under Rule 144.

"Bad Actor" Disqualification Provisions:

The proposed rules will substantially conform the "bad actor" disqualification provisions of Rule 262 to new Rule 506(d) and add a new disclosure requirement similar to Rule 506(e) (for a discussion of these rules see http://www.hinshawlaw.com/newsroom-publications-alerts-524.html).

Purchase Limits

Under the proposal, investors would have to be made aware of the investment limitations, but would otherwise be able to rely on an investor's representation of compliance with the proposed investment limitation unless the company knew, at the time of sale, that any such representation was untrue.

The SEC is soliciting comment on whether verification of the income and net worth limit should be required.

Integration

The proposed rules would generally preserve the existing Reg A integration safe harbors. As a consequence, Reg A offerings will not be integrated with any of the following:

- prior offers or sales of securities; or
- subsequent offers and sales of securities that are:
  - registered under the Securities Act, except as provided in Rule 254(d);
  - made in reliance on Rule 701 under the Securities Act;
  - made pursuant to an employee benefit plan;
  - made in reliance on Regulation S; or
  - made more than six months after completion of the Reg A offering.

There is no presumption that offerings outside the Reg A integration safe harbors should be integrated. A Reg A offering should not be integrated with another exempt offering, as long as each offering complies with the requirements of the exemption that is being relied upon for the particular offering.

The proposed rules would add to the list of safe harbor provisions subsequent offers or sales of securities made pursuant to the proposed rules for crowdfunding transactions under Title III of the JOBS Act (for a discussion of the proposed crowdfunding rules, see http://www.hinshawlaw.com/newsroom-publications-alerts-556.html). A company contemplating a crowdfunding transaction subsequent to any offers or sales conducted in reliance under the proposed Reg A rules should review the crowdfunding rules to ensure compliance with the advertising provisions of that proposed exemption.

The proposed rules would provide that where a company decides to abandon a Reg A offering and start a registered offering, any Tier 1 or Tier 2 offers made pursuant to Reg A would not be subject to integration with the registered offering, unless the company engaged in solicitations of interest in reliance on Reg A to persons other than qualified institutional buyers ("QIBs") and institutional accredited investors. A company soliciting interest in either a Tier 1 or Tier 2 offering to persons other than QIBs and institutional accredited investors must wait at least 30 calendar days between the last solicitation of interest and the filing of the registration statement with the SEC.

Registration with the SEC

Section 12(g) of the 1934 Act requires, among other things, that a company with total assets exceeding $10,000,000 and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, register such class of securities with the SEC.

Title III of the JOBS Act includes a provision regarding the treatment under Section 12(g) of securities issued in crowdfunding transactions pursuant to Section 4(a)(6) of the 1933 Act (see http://www.hinshawlaw.com/newsroom-publications-alerts-556.html for a discussion of these rules). Section 401 of the JOBS Act, however, does not include a similar provision directing how Reg A companies should be treated under Section 12(g).

The SEC has indicated that under the proposed rules, Reg A companies will not be exempt from the requirements of Section 12(g). Therefore, they will have to register with the SEC if they cross the record holder threshold.

The SEC is seeking comment on whether Reg A companies should be exempt from the Section 12(g) registration requirements.

Preemption of Blue Sky Law

Currently, Reg A offerings are subject to registration and qualification requirements in the states where the offering is conducted unless a state-level exemption is available.

Under the proposed rules, state securities law requirements would be preempted for Tier 2 offerings. The North American Securities Administrators Association has vigorously objected to this preemption rule.

Conclusion

The proposed rules may provide an avenue which will allow companies to raise capital without having to comply with the burdensome rules of the SEC registration process as well as becoming subject to the complex SEC reporting regime. As noted above, however (see **"Additional Tier 2 Requirements"**), the proposed rules for Tier 2 offerings will require companies to file ongoing reports thereby causing companies to incur additional costs. Companies will have to weigh these costs against the benefits of conducting a Tier 2 offering when deciding whether to undertake a Tier 2 offering.

For further information on the proposed Reg A rules, please contact Tim Sullivan (tsullivan@hinshawlaw.com), Mike Morehead (mmorehead@hinshawlaw.com) or your regular Hinshaw attorney.
