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Client Alert

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SEC Adopts Rules to Increase Access to Capital for Smaller Companies

On March 25, 2015, the SEC, as directed by Section 401 of the JOBS Act, adopted rules which significantly amend Regulation A.

On December 18, 2013, the SEC proposed amendments to Regulation A intended to implement Section 401. Generally speaking, the final rules follow the approach set forth in the proposed rules.

The final rules should be effective in late May or early June.

Regulation A

Regulation A is a longstanding, little used, exemption which allows companies to sell securities and avoid complying with the rules adopted under the Securities Act of 1933 (the "1933 Act") relating to the registration of securities offerings. Currently, 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.

Companies relying on the old 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, tailored 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 has been 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.

Reg A+

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

- Tier 1 offerings will consist of securities offerings of up to $20 million in a 12-month period, including sales for the account of selling security-holders equal to the lesser of $6 million or 30% of the aggregate offering price (including sales by the issuer).

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

the lesser of $15 million or 30% of aggregate offering price (including sales by the issuer).

For offerings up to $20 million, a company could elect to proceed under either Tier 1 or 2.

The new rules permit “test-the-waters” communications (see, "**Offering Communications**") for Tier 1 and 2 offerings and disqualify issuers involved with bad actors (see, "**Bad Actor Disqualification Provisions**").

The new rules will require issuers to electronically file disclosure documents with the SEC but impose different disclosure requirements for issuers involved in Tier 1 and Tier 2 offerings. In addition, the rules will allow issuers to submit offerings to the SEC on a confidential basis. (See, "**Filing and Delivery Requirements**" and "**Offering Statements on Form 1-A – Financials**"). An issuer completing a Tier 2 offering will be required to comply with periodic reporting rules (see, "**Ongoing Reporting**").

Tier 2 offerings will be subject to investment limits as discussed below (see, "**Purchase Limits**"). Tier 2 offerings will be exempt from the state registration and qualification rules (see, "**Preemption of Blue Sky Law**").

The rules permit brokers to rely on reports filed by a Reg A issuer making a Tier 2 offering to satisfy the broker’s obligations under Rule 15c2-11 (see, "**Secondary Trading**") and impose restrictions on secondary sales by security-holders following the completion of a Tier 1 or 2 offering (see, "**Resale Limits**").

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

An issuer completing a Tier 2 offering will not have to register under Section 12(g) of the 1934 Act as long as it complies with the limits discussed below (see, "**Registration with the SEC**").

Eligible Securities

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

Asset-backed securities may not be sold in a Reg A offering.

Eligible Issuers

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

The Reg A exemption would not be available to the following issuers:

- SEC reporting companies;
- Companies registered or required to be registered under the Investment Company Act of 1940 and business development companies ("BDCs");
- Blank check companies;
- Companies seeking to offer and sell or fractional undivided interests in oil, gas, or other mineral rights;
- Companies that have not filed the ongoing reports required by the final Reg A rules during the preceding two years;
- Companies subject to an SEC order revoking registration under the 1934 Act during the preceding five years; and
- Companies disqualified under the "bad actor" disqualification rules (see, "**Bad Actor Disqualification Provisions**").

Communications During an Offering

Companies may "test the waters" in order to 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 the offering statement has been publicly filed 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 must contain specified legends and must be submitted or filed as an exhibit when the offering statement is either submitted for non-public review or publicly filed (and updated for substantive changes in such material after the initial non-public submission or filing).

Solicitation materials do not have to be submitted to the SEC at or before the time of first use.

Filing and Delivery Requirements

Whether relying on Tier 1 or Tier 2, a company will be subject to the following filing and delivery requirements:

- Companies must electronically file offering statements.
- Companies may 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**").

- Companies must deliver a preliminary offering circular at least 48 hours in advance of a sale. However, an issuer that is subject to, and current in, its Tier 2 reporting obligations need only comply with the general delivery requirements for offers.

- 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 may be obtained on EDGAR and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and received in response.

- Companies undertaking 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—see, "**Ongoing Reporting**").

Qualification

Under the rules, an offering statement would have to be qualified by order of the SEC. In addition, the Division of Corporate Finance, acting pursuant to delegated authority, may declare an offering statement qualified by issuing a "notice of qualification" which is similar to notice of effectiveness.

Offering Statement on Form 1-A – General Content

Under the final rules, companies would continue to file an offering statement on Form 1-A as revised. The rules 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.

The Offering Circular (Model B Narrative) will require various disclosures, requiring companies to provide information about:

- basic 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 for the prior three years and a description of material physical properties;

- management discussion and analysis of the company's liquidity and capital resources and results of operations covering the two most recent fiscal years and any interim period;
- information about executive officers and directors including compensation;
- beneficial ownership information for executive officers, directors and 10% stockholders;
- related party transactions;
- material term of the offered securities;
- financial statements for the preceding two years and any interim period; and
- any events that would have triggered disqualification of the offering under the "bad actor" provision of the rules that occurred before the effective date of the rules (see "**Bad Actor Disqualification Provisions**").

Offering Statement on Form 1-A – Financials

Tier 1 and Tier 2 issuers must file balance sheets and related financial statements for the two previous fiscal year ends (or for such shorter time that they have been in existence).

U.S. issuers must prepare the financials in accordance with GAAP while Canadian issuers can use GAAP or IFRS as adopted by the IASB. Issuers in Tier 2 offerings may make a one-time election to delay adopting new accounting standards as long as non-public business entities are allowed to delay adopting the same standards.

Tier 2 issuers must include audited financial statements in their offering statements that are audited in accordance with either GAAS or the standards of the Public Company Accounting Oversight Board (PCAOB). The accountants must be independent but they do not have to be registered with the PCAOB.

Issuers in Tier 1 offerings do not have to provide audited financials. However, if the issuer has already obtained audited financials prepared in accordance with GAAP or PCAOB standards and the accountants satisfy the independence standards, then the audited financials must be filed. However, the accountants do not have to be registered with the PCAOB.

Tier 1 and Tier 2 issuers must include financial statements in Form 1-A that are dated not more than nine months before the date of non-public submission, filing, or 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.

Ongoing Reporting

The ongoing reporting rules provide that:

- Issuers that conduct a Tier 1 offering must 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 containing information about sales in such offering and an update of certain information.

- Issuers relying on Tier 2 exemption will 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 will be filed on a new Form 1-K; the semiannual report will be filed on new Form 1-SA and the current event reports will be filed on Form 1-U.

- Form 1-K will 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.

- 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 security-holders;

    - 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 10% or more of outstanding equity securities.

- These reports will 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.

- The reporting obligations of a Tier 2 issuer will be suspended when it becomes subject to the ongoing reporting requirements of Section 13 of the 1934 Act. These reporting obligations may also be suspended under Regulation A at any time by filing a Form 1-Z exit report after completing reporting for the fiscal year in which an 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, or fewer than 1,200 persons for banks or bank holding companies, and offers or sales made in reliance on a qualified Tier 2 Regulation A offering statement are not ongoing.

- Companies that conduct a Tier 2 offering must 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.

Secondary Trading

The rules include provisions designed to facilitate the development of secondary trading markets for securities issued in connection with Tier 2 offerings. Brokers will be permitted to rely upon information contained in reports filed by Tier 2 companies to satisfy the broker's obligations under 1934 Act Rule 15c2-11.

The SEC decided that Reg A reports may not serve as the basis for satisfying the current information requirements under Rule 144 or Rule 144A. However, if a Tier 2 submits quarterly information reports containing information similar to what is required in a Form 1-SA, it will be deemed to satisfy the current information requirements.

Resale Limits

The rules limit secondary sales by affiliates of the issuer that occur following the expiration of the first year after an issuer's initial qualification of an offering statement to no more than $6 million, in the case of Tier 1 offerings, or no more than $15 million, in the case of Tier 2 offerings, over a 12-month period.

Secondary sales by non-affiliates of the issuer that occur following the expiration of the first year after an issuer's initial qualification of an offering statement will not be limited except by the maximum offering amount permitted by either Tier 1 or Tier 2.

"Bad Actor" Disqualification Provisions

The rules substantially conform to the "bad actor" disqualification provisions of Rule 506(d) of Regulation 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). An issuer that cannot comply with these rules is not eligible to conduct a Tier 1 or 2 offering.

Purchase Limits

There are no investment limitations for purchasers in Tier 2 offerings who qualify as accredited investors under Rule 501 of Regulation D.

In a Tier 2 offering, an investor who is not an accredited investor will 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 will be calculated for individuals as provided in the accredited investor definition in Regulation D. Non-natural persons are subject to these investment limitations and should calculate the limitation based on no more than 10% of the greater of the purchaser's revenue or net assets (as of the purchaser's most recent fiscal year end).

The company will be allowed to rely on the representations of the purchasers of the securities that they are not exceeding these limits.

Tier 2 issuers will have to advise investors of these limitations.

The investment limitations discussed above will not apply to the sale of securities that will be listed on a national securities exchange upon qualification since such issuers will be required to meet the listing standards of a national securities exchange and will become subject to ongoing 1934 Act reporting.

There are no investment limitations for a Tier 1 offering.

Integration

The final rules 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 255(c);
    - made in reliance on Rule 701 under the Securities Act;
    - made pursuant to an employee benefit plan;
    - made in reliance on Regulation S;
    - made pursuant to Section 4(a)(6) of the Securities Act (crowdfunding transactions); 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 rules 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.

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, to register such class of securities with the SEC. For banks and bank holding companies, the record holder threshold is 2,000.

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 final rules provide that securities issued in Tier 2 offerings are exempt from the provisions of Section 12(g) for so long as:

- the issuer remains subject to, and is current in (as of its fiscal year end), its Regulation A periodic reporting obligations;
- the issuer engages the services of a transfer agent registered with the SEC pursuant to Section 17A of the 1934 Act; and
- the issuer meets requirements similar to those in the "smaller reporting company" definition under 1933 Act and 1934 Act rules. This conditional exemption is limited to issuers that have a public float of less than $75 million, determined as of the last business day of its most recently completed semiannual period, or, in the absence of a public float, annual revenues of less than $50 million, as of the most recently completed fiscal year.

Section 12(g) registration will be required if on the last day of a fiscal year: (i) the company exceeded the public float threshold or the annual revenue threshold, and (ii) the company has total assets of more than $10 million and the class of equity securities is held by more than 2,000 persons or 500 persons who are not accredited investors (item (ii) being the "12(g) Threshold").

An issuer that exceeds public float or annual revenue threshold and the Section 12(g) Threshold will be granted a two-year transition period before it would be required to register its class of

securities pursuant to Section 12(g), provided it timely files all ongoing reports due pursuant to Rule 257 during such period.

In such circumstances, an issuer that exceeds the thresholds will be required to begin reporting under the 1934 Act the fiscal year immediately following the end of the two-year transition period. An issuer entering 1934 Act reporting will be considered an "emerging growth company" to the extent the issuer otherwise qualifies for such status.

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. Tier 1 offerings will be subject to these state registration and qualification requirements.

Under the rules, state securities law requirements will not apply to Tier 2 offerings made to "qualified purchasers" A qualified purchaser is defined as any person to whom securities are offered or sold in a Tier 2 offering.

Conclusion

The 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. Issuers relying on Tier 1will not incur these additional costs but their offerings will be limited to $20 million.

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.
