Small Cap Securities Update

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Published by the Public Companies Practice Area to provide timely and useful information to CEOs, CFOs and general counsel

March 2014

SEC Proposes Regulation A+ To Assist Nonpublic Companies in Raising Capital

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Pursuant to the Jumpstart Our Business Startups Act of 2012 (JOBS Act), on December 18, 2013, the United States Securities and Exchange Commission (SEC) proposed significant amendments to Regulation A, which we refer to as Regulation A+. The proposed exemption permits nonpublic companies to raise up to $50 million by selling free-trading securities to the general public. This new exemption is intended to provide another avenue for private companies to access the capital markets to raise a significant amount of capital without going through the IPO process.

The Two Tiers of Regulation A+

In its current form, Regulation A is a seldom-used exemption that allows nonpublic companies to raise up to $5 million within a 12-month period without having to file a registration statement with the SEC. The lack of Regulation A offerings prompted public commentary suggesting that Regulation A be expanded and updated to make it more useful. Proposed Regulation A+ would provide exemptions from registration for two tiers of offerings:

- **Tier 1 Offerings** - would exempt small offerings of up to $5 million within a 12-month period, including no more than $1.5 million on behalf of selling security holders. Tier 1 offerings under Regulation A+ are essentially the same as offerings under the current Regulation A. Tier 1 offerings would remain subject to state blue sky registration and qualification, and issuers would have very limited disclosure obligations after qualifying the offering.
- **Tier 2 Offerings** - would raise the offering size limit to $50 million within a 12-month period, including no more than $15 million on behalf of selling security holders. Tier 2 offerings would be exempt from blue sky registration and qualification requirements, but would be subject to stricter offering statement disclosure requirements, including providing audited financial statements. In addition, issuers would be subject to ongoing reporting obligations, including the filing of annual, semiannual and current reports with the SEC.

Who Can Use Regulation A+?

Regulation A+ would be available to all issuers organized and with their principal place of business in the United States or Canada, with the exception of:

- SEC reporting companies
- Investment companies
- Shell companies
- Issuers of fractional undivided interests in oil, gas or other mineral rights
- Issuers disqualified by Regulation A's "bad actor" provisions
- Issuers that have not filed ongoing reports required by Regulation A during the two years preceding the filing of the offering statement
- Issuers that have been subject to an SEC order denying, suspending or revoking their Exchange Act registration within five years before the filing of the offering statement

What Are the Investment Limitations Under Regulation A+?

Offers and sales may be made to any investor and are not limited solely to accredited investors. Investors in Tier 2 offerings may invest an amount equal to the greater of 10 percent of their annual income or net worth. Although Tier 2 issuers would be required to inform investors of the investment limit, they would not need to verify investor compliance. Instead, issuers could rely on an investor's representation of compliance with such limits unless the issuer knew, at the time of sale, that the representation was false.

What Types of Securities Can Be Offered Under Regulation A+?

- Equity securities
- Debt securities
- Debt securities convertible or exchangeable into equity
- Options and warrants exercisable for such securities

What Is the Filing Process?

Issuers will be required prepare and file with the SEC an offering statement on Form 1-A, which will be subject to SEC review and could only be qualified by an SEC order. All filings and nonpublic submissions in the Regulation A+ qualification process would be made via the SEC's online EDGAR system. Issuers would be required to publicly file an offering statement no more than 21 calendar days before the offering statement is qualified. There would be no filing fees associated with nonpublic

submissions, filings or amendments of Form 1-A and issuers could request confidential treatment for certain information.

What Is the Offering Process?

- No offers could be made until the Form 1-A is filed, with the exception of certain "testing the waters communications".
- After Form 1-A is filed, but before qualification:
  - Oral offers could be made;
  - Written offers could be made if they comply with Rule 254, which requires offers be made by means of a preliminary offering circular bearing certain legends, containing substantially the information required by Form 1-A, except information permitted to be omitted under proposed Rule 253; and
  - "Testing the waters communications" meeting the requirements of Rule 255 could be made.
- After Form 1-A has been qualified, any written offers would have to be accompanied with or preceded by the most recent offering circular filed with the SEC for the offering.

What Information Must Be Included in the Offering Statement on Form 1-A?

- Part I – Notification would require:
  - Issuer's basic information
  - Issuer eligibility
  - Applicability of "bad actor" disqualification provisions
  - Summary information about the offering and other current or proposed offerings
  - Jurisdictions where the securities are being offered
  - Unregistered securities issued or sold within one year of the offering
- Part II – Offering circular would require extensive disclosure, including:
  - Identity of any underwriters and underwriting discounts
  - Material risks related to the offering
  - Material disparities between public offering price and acquisition cost of insiders
  - Use of proceeds
  - Business operations for the past three years
  - Material physical properties
  - Discussion and analysis similar to MD&A
  - Information regarding directors, officers and significant employees
  - Executive compensation
  - Beneficial ownership table
  - Related party transactions
  - Material terms of the offered securities
  - Two years of GAAP financial statements dated within nine months of the filing (Tier 2 must be audited)
  - Disclosure of participation of any "bad actors" whose participation would have disqualified the issuer from relying on the exemption but for that the underlying events occurring prior to the effective date of Regulation A+
- Part III – Exhibits would include any underwriting agreement, the issuer's charter and bylaws, material contracts, consents, legal opinion, and all written or broadcast testing the waters communications.

What Are the Ongoing Reporting Obligations?

Tier 2 issuers would be subject to reporting requirements similar to public companies as follows:

- Annual report on new Form 1-K, which is similar to a Form 10-K but with scaled-back disclosure items. Required to be filed within 120 days after the issuer's fiscal year end and include two years of audited financial statements.
- Semiannual report on new Form 1-SA, which is similar to a Form 10-Q but with scaled-back disclosure items. Required to be filed within 90 days after the end of the issuer's second fiscal quarter and include unaudited financial statements.
- Current reports on new Form 1-U, which is similar to Form 8-K but with materially less triggering events. Form 1-U would be required to be filed within four business days after a triggering event.

What's Next?

In its proposing release, the SEC sought specific comment on virtually every material provision. Based on the timeline for other JOBs Act related proposals, final rules may not be forthcoming for some time.

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