SEC Radically Revamps Regulation A - Part 1

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Eligibility and Offering Size

For many years, SEC Regulation A languished as an exemption from registration that nobody really used. Although securities issued in a Regulation A offering are not "restricted securities" and are thus freely tradable (if there is a market), the exemption was cumbersome, unfamiliar to both investors and securities practitioners, and limited to $5 million. Regulation D, particularly Rule 506, has been exponentially more important in the capital markets as a way for private companies to raise money.

Under the JOBS Act, which became law in April 2012, the SEC was directed to revise Regulation A so as to make it useable and available for offerings up to $50 million. On March 25, 2015, the Commission promulgated final rules and regulations to amend Regulation A. The new rules will become effective **June 19, 2015**. The dramatically altered Regulation A has been nicknamed "Regulation A+" but in this Alert we will simply refer to it as Regulation A.

This Alert is in three parts (**click here** for Part 2, **click here** for Part 3). **Part 1** focuses primarily on eligible and ineligible issuers, eligible and ineligible securities, offering limitations, limitations on secondary sales, investment limits for non-accredited investors, integration of Regulation A offerings with other offerings, and treatment of Regulation A transactions for purposes of Section 12(g) of the Exchange Act.

Eligible and Ineligible Issuers

Regulation A may be used by companies organized and with a principal place of business in the United States or Canada.

However, the following are **ineligible** to use Regulation A:

- Companies that file periodic reports under the Exchange Act – that is, public companies;
- Investment companies, including business development companies;
- Blank check companies, which are development stage companies that have no specific business plan or have stated that their business plan is to engage in a merger or acquisition with an unidentified company or companies;
- Issuers of fractional undivided interests in oil, gas or mineral rights;
- Issuers subject to "bad actor" disqualification under Rule 262 of Regulation A;
- Issuers that are required to, but that have not, filed with the SEC the ongoing reports required by Regulation A during the two years immediately preceding the filing of a new offering statement under Regulation A; and
- Issuers subject to any order by the SEC denying, suspending, or revoking the registration of a class of securities pursuant to Section 12(j) of the Exchange Act that was entered within five years before the filing of a new offering statement under Regulation A.

Eligible Securities

Regulation A limits the types of securities eligible for offer and sale under Regulation A to those specifically enumerated in Section 3(b)(3) of the Securities Act, namely, the following:

- Equity securities;
- Debt securities; and

- Debt securities convertible or exchangeable into equity interests, including any guarantees of such securities.

Notably, the list of eligible securities excludes asset-backed securities. The SEC does not believe that Section 401 of the JOBS Act was intended to facilitate the issuance of such securities, which are subject to the provisions of Regulation AB.

Regulation A Offering Limitations

The old regime's $5 million offering limit was often impractical in light of transaction expenses that could include significant legal and accounting fees. In response, Regulation A now contemplates two tiers of offerings:

- Tier 1 for offerings of up to $20 million of securities in a 12-month period; and
- Tier 2 for offerings of up to $50 million of securities in a 12-month period.

The SEC expects that the increase in permissible offering size will increase the feasibility of a Regulation A offering for small to medium sized companies. The $50 million offering limit under Tier 2 is likely to make such an offering impractical for larger issuers, which are expected to rely on registered offerings under the Securities Act. The Tier 2 limit may increase in the future, as the JOBS Act requires the SEC to review these offering limitations every two years.

Secondary Sales Under Regulation A

Regulation A limits the amount of securities that selling security holders can sell at the time of an issuer's first Regulation A offering and within the following 12 months to no more than 30% of the aggregate offering price of the particular offering. The new rules also distinguish between affiliates and non-affiliates of the issuer in the following ways:

- Secondary sales by affiliates after the first 12 months following the offering are limited to:
  - $6 million (30% of the maximum offering) over a 12-month period in the case of Tier 1 offerings; and
  - $15 million (30% of the maximum offering) over a 12-month period in the case of Tier 2 offerings;
- Secondary sales by non-affiliates made pursuant to a qualified offering statement after the first 12 months following the offering are not limited except by the maximum offering amount permitted by either Tier 1 or Tier 2, whichever is applicable.

Calculation of Offering Limits

For purposes of calculating compliance with the maximum offering amount permissible under each Tier, Regulation A requires that issuers must aggregate the price of all securities for which qualification is currently being sought. This calculation must include securities underlying any rights to acquire that are convertible, exercisable, or exchangeable within the first year after qualification or at the discretion of the issuer. Also, in instances in which the underlying securities use a pricing formula as opposed to a known conversion price, the issuer will be required to use the maximum estimated price.

Investment Limits for Non-Accredited Investors

There is no legal limit to the amount of securities that an **accredited** investor may purchase in a Regulation A offering, and no limits on anyone in a Tier 1 offering.

In a nod to crowdfunding, Regulation A allows **non-accredited** investors to purchase in a Tier 2 offering subject to investment limits. That is, a non-accredited investor may not invest more than 10% of the greater of the investor's annual income or net worth (exclusive of principal residence). In the case of non-accredited entities, the 10% investment limit is based on the investing entity's revenue or net assets. If the non-accredited investor is buying securities that are convertible into or exercisable or exchangeable for, other securities, the same calculation described above will apply.

The investment limit does not apply to investments in securities that will be listed on a national securities exchange upon qualification.

The burden is on the issuer to make each investor aware of the investment limit. However, as distinct from the verification requirement in Rule 506(c), the issuer in a Regulation A sale may rely on a representation by the investor as to compliance with the purchase limits, provided that the issuer does not have actual knowledge to the contrary at the time of sale.

Integration Issues

The SEC adopted a generous integration safe harbor for offerings pursuant to Regulation A, exempting them from integration with:

- Prior offers or sales of securities (including private offerings under Section 4(a)(2) of the Securities Act or Rule 506 of Regulation D); or
- Subsequent offers and sales of securities that are:
    - Registered under the Securities Act, except as provided in Rule 255(e) (dealing with abandoned offerings);
    - Made pursuant to Rule 701 under the Securities Act (dealing with compensatory plan securities);
    - Made pursuant to an employee benefit plan;
    - Made pursuant to Regulation S (dealing with "off-shore" offerings);
    - Made pursuant to Section 4(a)(6) of the Securities Act (dealing with federal crowdfunding); or
    - Made more than six (6) months after completion of the Regulation A offering.

Favorable Treatment Available under Section 12(g) of the Exchange Act

Section 12(g) of the Exchange Act requires that an issuer with total assets exceeding $10 million 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 under the Exchange Act. Regulation A exempts securities issued in a **Tier 2** offering from the registration requirement of Section 12(g) as long as:

- The issuer remains subject to, and is current in, its Regulation A periodic reporting obligations; and
- The issuer engages the services of a transfer agent registered with the SEC pursuant to Section 17A of the Exchange Act.

In addition, the above exemption is only available to issuers that resemble "smaller reporting companies" in that they have a public float of less than $75 million or, in the absence of a public float, annual revenues of less than $50 million. An issuer that exceeds these thresholds is granted a two-year transition period before being required to register under Section 12(g).

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