**January 23, 2019**

# Understanding Regulation A+

## What is Regulation A+?

On July 19, 2015, the Securities and Exchange Commission (SEC) instituted a significant amendment to Regulation A, an existing registration exemption under the Securities Act of 1933 (Securities Act). As mandated by the Jumpstart Our Business Startups Act (JOBS Act), the SEC increased the amount of capital that startup and emerging companies could raise under Regulation A from $5 million to up to (i) $20 million for Tier 1 offerings and (ii) $50 million for Tier 2 offerings, earning the nickname Regulation A+ (Reg A+).[1]

## Who uses Reg A+ and how?

Since its inception, over 300 issuers have raised approximately $1 billion pursuant to Reg A+. While most Reg A+ issuers have been operating companies, issuers have also taken advantage of Reg A+ to form Real Estate Investment Trusts (REITs) and conduct M&A activity. Issuers in industries as diverse as real estate, financial services, medical services, motor vehicles, film, and computer services have taken advantage of Reg A+. Among other uses of capital, Reg A+ issuers have deployed capital to flip houses, renovate ski resorts, develop solar technology, perform clinical research, and produce innovative motorized vehicles.

In a 2016 SEC review, the median filer had less than $100,000 in total assets, no revenue, no income, and three employees. In that same review, the average filer had $50.8 million in assets, $2.8 million in revenues, $2 million in income, and 47 employees. While the usage of Reg A+ by some larger, more developed companies skewed the average assets, revenue, income, and employee statistics higher, the vast majority of issuers were comprised of small, early-stage companies with limited collateral, restricting their ability to obtain a small business loan or other debt financing on reasonable terms.

In the 2016 review, the majority of issuers offered equity securities (87%), some issuers offered debt securities (9%), and a few issuers offered other security products (4%). While the majority of Reg A+ issuers have offered common stock, issuers have also offered preferred stock, promissory notes, simple agreements for future equity (SAFEs), revenue sharing plans, and investment multipliers. Additionally, while it is still in its infancy, some issuers are seeking to utilize Reg A+ to offer blockchain-asset tokens as part of security token offerings (STOs).

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[1] In March 2018, the U.S. House of Representatives passed the Regulation A+ Improvement Act of 2017. The bill would increase the Tier 2 cap to $75 million. The Senate has not voted on the bill yet.

## Determining Eligibility

Reg A+ is solely available to companies organized and with a principal place of business in the United States or Canada. While the SEC stopped short of limiting Reg A+ solely to operating companies,[2] operating companies are best suited to qualify for the exemption. Reg A+ is unavailable to:

- investment companies (companies primarily engaged in the business of investing in securities) and business development companies (closed-end funds that invest in small and emerging businesses);[3]
- blank check companies (companies without an established business plan or formed for the purpose of merging into another business);
- issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights;
- issuers that are or have been subject to an order by the Commission denying, suspending, or revoking the registration of a class of securities pursuant to Section 12(j) of the Securities Exchange Act of 1934 that was entered within five years before the filing of the offering statement;
- issuers that fail to comply with Reg A+ ongoing filing requirements; and
- certain bad actors.

Previously, companies subject to the ongoing reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (Exchange Act) were ineligible to utilize Reg A+. In such cases, reporting companies were required to utilize subsidiaries to issue securities pursuant to Reg A+, so long as the parent reporting company did not serve as a guarantor or co-issuer. However, in May of 2018, Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act (Act), which ordered the SEC to amend Reg A+ to give SEC-reporting companies the ability to issue securities pursuant to Reg A+. Additionally, the Act ordered the SEC to amend Reg A+ so that any company subject to Section 13 or 15(d) of the Exchange Act will be deemed to have met the periodic and current reporting requirements of Reg A+ if such issuer meets the Exchange Act reporting requirements.

If an issuer is qualified to offer and sell securities, it may do so in the form of:

- equity securities
- debt securities
- securities convertible into or exchangeable into equity interests (i.e. warrants); and
- guarantees of such securities.

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[2] As expressly indicated by the SEC in its rules for adoption.

[3] There may be some circumstances in which a venture capital fund would be qualified to utilized Reg A+, but hedge funds, private equity funds, and venture capital funds are generally prohibited from using Reg A+, including those funds that are exempt from the Investment Company Act of 1940 pursuant to 15 U.S.C. 80a-3(c)(1) and 15 U.S.C. 80-3(c)(7).

Asset-backed securities are expressly ineligible for Reg A+. Although not expressly listed or contemplated in the in the SEC's final rule release, blockchain-based tokens can be structured as debt, equity, or potentially new types of securities to meet the SEC's eligibility requirements.

## The Two Tiers

Once an issuer determines it is eligible to participate in Reg A+, it must decide whether to proceed pursuant to Tier 1 or Tier 2. Each tier has unique characteristics, but the most critical is that Tier 1 issuers can raise up to $20 million over a 12-month period, and Tier 2 issuers can raise up to $50 million over a 12-month period.

| | Tier 1 | Tier 2 |
|---|---|---|
| Offering Limit | $20 million over 12 months | $50 million over 12 months |
| Issuer Affiliate Sales | Maximum of $6 million in the first 12 months | Maximum of $15 million in the first 12 months |
| Disclosure Requirements | Offering Circular with mandated disclosure filed with states and SEC | Offering Circular with mandated disclosure filed with the SEC and provided to the states |
| Financial Statement Requirements | GAAP financials required, but no audit obligation | US GAAP audited financial statements |
| Review Process | SEC and State review | SEC review |
| Blue Sky Requirements | Must comply with state blue sky rules | Preempted from state blue sky rules |
| Ongoing Reporting | Exit Report Required | Annual (audited), semi-annual (unaudited), current reports for certain events, and exit report required |

As seen in the table above, Tier 1 offerings are not required to obtain or provide audited financials (although some states may impose such a requirement) and are subject to far less onerous ongoing reporting requirements. Tier 2 offerings must obtain and provide audited financials prior to an offering and must provide ongoing reporting for offerings that are actively being conducted.

If the issuer is offering an instrument that is convertible, exercisable, or exchangeable in the first year after qualification or at the discretion of the issuer, the issuer must use the aggregate price of that instrument in its offering limit calculation.

## Investment Limits

While Tier 1 offerings of Reg A+ do not have investment limits, Tier 2 offerings place investment limits on non-accredited investors. Non-accredited, natural persons can invest up to 10% of either the investor's (i) annual income or (ii) net worth, whichever is greater. An investor's net worth is determined in accordance with Rule 501 of Regulation D (Reg D) under the Securities Act. Non-accredited, non-natural persons can invest up to 10% of the purchasers (i) revenue or (ii) net assets, whichever is greater.

These limitations do not apply to Reg A+ offerings that are listed on a national exchange. Additionally, while Reg A+ issuers must make investors aware of investment limitations, Reg A+ issuers may rely on investor representations unless the issuer has knowledge any such representation is untrue.

## Why Reg A+?

Companies that need to raise capital generally do so through the issuance of securities. Such securities must either be registered or exempt from registration. While some entities may choose to register an offering, the majority of securities offerings are issued pursuant to an exemption. While other exemptions (such as Rule 147/147A offerings) may be appropriate in limited circumstances, most startup and emerging companies take advantage of (i) Rule 506 under Reg D, (ii) Reg A+, or (iii) Regulation Crowdfunding (Reg CF) under the Securities Act.

*RULE 506 OF REG D*

The Reg D offering exemption (Rules 506(b) and 506(c)) allows issuers to raise an unlimited amount of capital through the issuance of securities from an unlimited number of accredited investors (although this is generally capped at 1,999 investors due to reporting implications). Offerings conducted pursuant to Rule 506 are not subject to any express disclosure or SEC-mandated submission or approval requirements. Rule 506 is the simplest and, generally, least laborious offering exemption available to startup and emerging companies.

However, Reg D offerings have trade-offs. Securities issued pursuant to Rule 506(b) offerings cannot be sold through the use of general solicitation and must instead be issued through private placement. Additionally, Rule 506(b) offerings can only be sold to a maximum of 35 non-accredited investors. The rest of the investors must be accredited, and most Rule 506(b) offerings will not issue securities to non-accredited investors due to heightened disclosure requirements. Rule 506(c) offerings can be sold through the use of general solicitation. However, each investor in a Rule 506(c) offering must be verified as an accredited investor.

It is estimated that approximately 8-10% of U.S. households qualify as accredited investors. Consequently, while Reg D offerings are the most flexible and easily administrated, the offerings are generally done on a private basis leaving a significant portion of the investing population without access to such offerings.

*REG CF*

Reg CF is another securities exemption that may be appropriate in certain circumstances for startups. Reg CF allows issuers to raise up to $1.07 million on a 12-month basis from accredited and non-accredited U.S. investors through general solicitation. Reg CF offerings must submit a Form C with the SEC prior to issuing securities. The Form C has mandatory disclosure requirements as well as financial information requirements that must be (i) prepared in accordance with GAAP, (ii) reviewed by a CPA, or (iii) audited by a CPA, depending on the amount raised. Additionally, Reg CF offerings must be sold through an approved crowdfunding portal.

Due to the fact that the SEC does not review, comment, or approve Reg CF filings, offerings conducted pursuant to Reg CF can be executed fairly quickly. However, Reg CF suffers from a relatively low offering cap, so the proceeds raised might not justify the cost of filing. Upfront accounting, legal, blue sky, and marketing fees are estimated to cost 5-15% of an offering, assuming the maximum amount is raised. On top of that, the approved crowdfunding portals that Reg CF offerings must use generally take between 5-10% of the final offering amount raised. At the end of the day, the cost of capital for Reg CF issuers can range from 10% to 25% or higher for a relatively small amount of capital raised.

*COMPARING THE EXEMPTIONS*

*Offering and Investor Limits* – While Reg D offerings can potentially raise an unlimited amount of capital, the rules of raising capital are highly restrictive. In the vast majority of cases, Reg D offerings are restricted to accredited investors; consequently, Reg D offerings generally require access to venture capitalists, angel investors, and other institutional investors. Reg CF offerings can potentially have an unlimited number of investors, but the $1.07 million offering limit will likely discourage most issuers. Reg A+ strikes a middle ground between Reg D and Reg CF. Subject to some additional disclosure requirements (covered below), Reg A+ allows issuers to raise up to $50 million from an unlimited number of investors, regardless of whether they are accredited.

*Liquidity and Transferability* – One of the biggest advantages of Reg A+ is liquidity. Subject to some restrictions addressed below, Reg A+ offerings are transferable upon issuance. Reg A+ offerings are unique in that they can be listed on an exchange upon issuance, providing sizeable liquidity and ease of transferability. In contrast, with limited exceptions, securities issued pursuant to Reg CF and Reg D are restricted for at least 12 months.

*Flexible Marketing and Investor Intake* – Rule 506(b) of Reg D prohibits general solicitations. Rule 506(c) of Reg D allows issuers to offer securities through general solicitation, but only accredited investors can actually invest. While Reg CF allows public advertising, issuers are heavily limited in what they can discuss outside of the funding portal's website. In contrast, Reg A+ does not impose heavy-handed restrictions on an issuer's method of public advertising. While disclaimers may be necessary, Reg A+ issuers can freely advertise through their chosen medium.

*Cost of Capital* – While Reg D offerings can be issued at a relatively low cost, the investor eligibility and marketing limitations of the exemption make it difficult to compare to Reg A+. Although Reg CF offerings can be relatively affordable in the aggregate, issuers may be forced to expend approximately 10-25% of the $1.07 million offering limit to cover their costs. A Reg A+ offering is costlier to conduct, but it is a more economically efficient method of raising capital compared to Reg CF.

The vast majority of Reg A+ offerings incur legal and accounting fees. More established companies may also include broker-dealer fees, promoter fees, and underwriting fees. If a Reg A+ issuer incurs legal, audit, promoter, underwriting, and broker-dealer fees, (as calculated using publicly available data on EDGAR) an issuer can expect to spend approximately $1.4 million or 2.8% of a $50 million raise. *However*, the majority of issuers that utilize Reg A+ do not hire broker-dealers, promoters, or underwriters and instead elect to self-issue and promote the offering, thereby only incurring legal, auditing, and marketing expenditures. Such issuers have been able to conduct offerings for ~$75,000-$100,000 – a 0.15% to 0.3% cost of capital on a $50 million raise (or between 0.375% to 0.75% cost of capital on a $20 million raise). In other words, while Reg A+ offerings often result in the highest aggregate expenditures, the low cost of capital makes it an attractive offering exemption, especially compared to other methods of capitalization.

*Ambassador Benefit* – Reg A+ also offers a unique perk (shared with Reg CF) that is difficult to quantify. Reg A+ offerings can trigger a grassroots marketing campaign. Although investors in Reg D offerings are incentivized to support the companies in which they invest, the accredited investor requirement limits the potential number of investors that can advocate for the company. In contrast, a well-run Reg A+ offering could potentially create tens of thousands of vested and loyal ambassadors in its investors. For example, if a small, 10-person company conducts a Reg A+ offering and sells $25 million of securities with an average investment of $500, that company just increased the number of people who care and are vested in the outcome of the company to 50,000. While this perk is hard to quantify, it is likely that investors will provide free word-of-mouth advertising and become a consumer of the issuing entity's product, if possible.

*Speed and Efficiency* – The biggest downside to Reg A+ compared to Reg D and Reg CF, is that Reg A+ issuers are the slowest to qualify the issuance of their securities. Because most Reg D offerings are solely limited to accredited investors, the SEC takes a very hands-off approach to regulation and does not mandate disclosure requirements or filing. Due to limited mandatory disclosure and filing requirements, Reg CF offerings are often not as quickly executed as Reg D offerings. However, although issuers are required to file a Form C with the SEC, there is no approval process, which significantly speeds up the process.

Reg A+, however, is far slower than Reg D and Reg CF. As with Reg CF, there is a filing requirement. Unlike Reg CF, Reg A+ filings are required to obtain SEC approval (qualification) prior to the sale of securities. According to a report in 2016, the average number of days to qualify an offering was 68 days for Tier 1 offerings and 104 days for Tier 2 offerings, although there is evidence that time frame is currently shorter.

## What about a Registered Offering?

Reg A+ and Reg CF share their exempt issuance status with Reg D, but while Reg D offerings are considered private offerings, Reg A+ and Reg CF fall into the public offering category as registered Initial Public Offerings (Registered IPOs). Reg A+ is often referred to as a “mini-IPO.” Although it shares a great number of similar characteristics with a Registered IPO, there are significant differences between the two.

*COST*

Over the last 20 years, the number of publicly listed U.S. companies has decreased by more than 50%. While there are a number of factors that likely contributed to the downsizing of the publicly traded market, including M&A activity, increased private equity activity, and depressed interest rates, a significant factor is the cost. It is estimated that publicly traded companies spend an estimated $3-6 million on one-time Registered IPO fees, *plus* a 4-7% underwriting fee of the amount raised. A company seeking to raise $100 million in a Registered IPO can expect to pay between $7 million and $13 million to conduct the offering. That translates to a 7-13% cost of capital, which is not particularly attractive considering today’s low cost of borrowing. In addition, Registered IPOs typically spend at least $1 million in annual, recurring compliance fees.

While Reg A+ offerings are generally more expensive than Reg D and Reg CF offerings (although Reg A+ has a much lower cost of capital than Reg CF), Reg A+ offerings are considerably less expensive than a Registered IPO. As noted above, if a Reg A+ issuer elects to hire a promoter, underwriter, and broker-dealer (on top of legal and accounting), a Reg A+ issuer is still only expected to spend approximately $1.4 million (a 2.8% cost of capital), even though the majority of Reg A+ issuers will spend far less. While still being able to publicly list their securities, Reg A+ offerings are approximately 80-90% less expensive than a Registered IPO.

*TIMING*

Registered IPOs are time-consuming and require considerable foresight. Registered IPOs require considerable planning, auditing, underwriter selection, due diligence, valuation, road shows, quiet periods, and an intrusive SEC review and comment process. Registered IPO issuers are generally instructed to budget 16-24 months from the beginning of the process to approval.

Reg A+ offerings are far more expedient. While Reg A+ offerings must generally still be audited and require considerable planning, Reg A+ offerings are conducted on a smaller scale with fewer moving pieces to slow down the process. Additionally, SEC review is quicker and less intrusive than a Registered IPO. Reg A+ is a better fit for smaller, less seasoned companies that may or may not be able to continue or expand operations without the infusion of additional capital for the 16-24 months it would take to conduct a Registered IPO. From drafting to qualification, it will take most Reg A+ issuers ~4-8 months to begin offering their securities to the public. This provides access to capital 3 to 5 times faster than a Registered IPO.

*OTHER FACTORS*

*Ongoing Reporting* - While Reg A+ issuers must stay current in semi-annual, annual, and current event filings, these filings are less cumbersome than the 10-Q, 10-K and 8-K reports registered offerings must file.

*Marketing* - Registered IPOs have considerable rules in place that inhibit marketing, such as quiet period requirements. Reg A+ offerings can test the market and actively advertise offerings on social media, websites, TV, radio, and any other medium of advertising before, during, and after qualification.

*Term Flexibility* - While Registered IPO issuers overwhelmingly issue common stock, Reg A+ issuers have considerable flexibility in the type of securities they offer. Such offerings can include preferred stock, promissory notes, SAFEs, security tokens, and any other security products the issuer can envision.

*WHEN TO CONDUCT A REGISTERED IPO*

Regardless of its efficiency, Reg A+ is not ideal for all issuers. Issuers who wish to conduct a public offering for more than $50 million (unless the cap is increased) in capital must do so pursuant to a Registered IPO. Additionally, issuers that conduct Registered IPOs may have an easier time being listed on large exchanges such as the NASDAQ and NYSE, which could provide immediate liquidity to all insiders. While the SEC does not impose Registered IPO lock-up periods, companies conducting a Registered IPO will generally institute a 90-180-day lock-up that prevents insiders from selling shares on the market. After the lock-up period, insiders can freely sell any amount of the securities they possess. While lock-up periods are not common in Reg A+ offerings, affiliate security holders and other insiders may only sell their shares in an amount equal up to 30% of the Reg A+ offering in the first year. While a Reg A+ offering is still a liquidity event for insiders, it can impose somewhat more restrictive divestment options for insiders in the first 12 months following an offering.

## Potential Expenses

*Audit* – Most issuers will be required to obtain an auditor. Tier 2 issuers are required to provide audited financials. Although Tier 1 issuers are not mandated to provide audited financials, they must still provide GAAP financials that should be, at the very least, reviewed by an auditor.

*Legal* – Some issuers have attempted to qualify offerings without legal counsel, but it is not advisable. As previously noted, Reg A+ issuers are required to qualify each offering. This involves getting the SEC, and potentially state regulators, to sign off on an offering circular as well as potentially dozens of relevant exhibits. Reg A+ is viewed as an abridged version of a Registered IPO, so it is subject to many of the same disclosure requirements as publicly traded companies.

*Broker-Dealer* – Some issuers may elect to utilize a broker-dealer to market and sell their securities. Broker-dealers must be registered with FINRA and authorized to effect transactions in securities. Broker-dealers generally keep a percentage of the securities they sell. This percentage must be disclosed on Form 1-A.

*Underwriters* – Certain issuers may choose to utilize an underwriter (18% of Reg A+ issuers utilized an underwriter in 2016). In traditional cases, underwriters will value a company, assume the issuer's risk through the purchase of its securities, and collect a fee on the resale of securities. However, the majority of underwriters that have provided services to Reg A+ issuers have done so on a best-efforts basis. In a best-efforts offering, underwriters agree to place as many securities as possible, but do not take responsibility for any unsold securities; this approach is likely due to the existing novelty surrounding Reg A+.

*Marketing/Promoting* –Marketing is perhaps the most important part of executing a successful Reg A+ offering. Unlike Reg D, Reg CF, and Registered IPOs, there are few restrictions on marketing Reg A+ offerings. There is also a great deal of potential variability in marketing strategies and budgets. Reg A+ issuers have conducted successful offerings, both by utilizing self-run social media campaigns and retaining major marketing firms.

### Integration

Companies that are raising capital may use multiple exemptions to accomplish their capital-raising goals. Doing so often raises the issue of integration. Reg A+ provides that Reg A+ offerings will not integrate with:

- 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 pursuant to Rule 701 under the Securities Act;
    - made pursuant to an employee benefit plan;
    - made pursuant to Regulation S;
    - made pursuant to Section 4(a)(6) of the Securities Act; or
    - made more than 6 months after completion of the Reg A+ offering.

The SEC noted in its discussion of Reg A+ that Reg A+ offerings should not be integrated with another exempt offering made by the Reg A+ issuer, provided that each offering complies with the requirements of the exemption that is being relied upon for the particular offering. This generally means issuers should be able to issue securities pursuant to Reg D, Reg CF, and Reg A+ concurrently or in quick succession, so long as the issuer curates its solicitation material.

## The Filing Process

While each offering will present its own unique set of processes that must be followed, most Reg A+ offerings will follow the formula discussed below. Depending on communication between counsel and the issuer, complexity of the offering, and SEC resources, the entire process can take anywhere from 3-6 months.

## Step One: Entity Formation

The first step of a Reg A+ offering for a new company is to form the entities. This involves incorporating the entity in the state(s) in which it will operate and drafting the documents related to the formation and management of the company. Existing companies will need to amend formation and governing documents in preparation for the forthcoming securities issuance.

## Step Two: Begin the Auditing Process

Newly formed entities can expect a simple, zero-asset audit. While such an audit may take a couple of weeks to conduct, newly formed entities should be able to undergo this process without substantial expense. Existing entities should begin the auditing process as soon as practicable. An audit of an existing operational company can take 4-8 weeks (or longer), and it involves some legwork by management on behalf of the entity. Issuers should get a jump on this process to prevent an unnecessary delay on filing.

## Step Three: Drafting and Filing the Offering Documents

Form 1-A is the document used to submit a Reg A+ offering. The Form 1-A is divided into 3 parts.

*Part I: Notification* – The notification filing is a pre-generated form, similar to a Form D, that is filled out and submitted online. The notification filing is a relatively short and simple form requiring information obtained during the Part II drafting process. Among additional information, the notification filing requires:

- General issuer information;
- A financial information table;
- Information concerning outstanding securities;
- Representations related to issuer eligibility to utilize Reg A+;
- Representations related to bad actor provisions;
- Summary information regarding the proposed offering, including fees paid in connection with the offering;
- Disclosure of jurisdictions in which the securities will be offered; and
- Information concerning securities sold within the last year.

*Part II: Offering Circular* – The offering circular is a scaled down version of a Form S-1 that issuers must file prior to conducting a public offering. Although the offering circular for a Reg A+ offering may be less voluminous than a Form S-1, Part II of Form 1-A is still a sizeable document and drafting an offering circular is a significant undertaking. Among other details, the SEC mandates that issuers discuss:

- Risk factors;
- Matters regarding dilution;
- Plan of distribution;
- Use of proceeds;

- Description of business and property;
- Management's Discussion & Analysis ("MD&A") of financial condition and results of operation;
- Directors, executive officers and significant employees;
- Director and executive compensation, ownership, and interest in transactions; and
- Type of securities being offered.

Furthermore, the offering circular must include Part F/S. Part F/S contains the relevant financial information mandated by Tier 1 or Tier 2.

*Part III: Exhibits* – As with a registered offering, Reg A+ offerings must also include relevant exhibits. Which exhibits to include is often a question of materiality. Some commonly required exhibits include:

- Charter and bylaws;
- Subscription agreements and documents defining the rights of security holders (such as promissory notes or stock certificates);
- Escrow agreements;
- Accountant certification letters;
- Consents of accountants, counsel, and any other professional authority;
- Testing the waters material; and
- Any other material contracts.

The SEC does mandate disclosure of certain exhibits, but many issuers will go above and beyond mandated requirements in an effort to provide investors with a more complete picture of the issuer's operations.

The Form 1-A drafting process is the point in which the issuer must make the most impactful decisions regarding the offering. Some of the decisions that must be made during this third step (prior to submission) include:

- The tier of the offering;
- What form of securities will be issued;
- Whether the issuer will utilize a broker-dealer;
- Whether the offering will be made on a continuous and delayed basis;
- The offering price of the securities;
- Whether the issuer will retain an underwriter;
- The issuer's marketing strategy; and
- The terms of the securities being offered.

While an issuer can revise its offering documents after submission to the SEC, each revision is likely to result in additional questions and comments throughout the qualification process, which can result in significant delays in qualification.

Once an issuer has prepared all three parts of Form 1-A, it must file all documentation through EDGAR.

## Step 4: The Qualification Process

The next step in the Reg A+ filing process is qualification. During the qualification phase, the SEC, state regulators, and the issuer will engage in back-and-forth discussions regarding the offering, generally through the use of comment letters and open dialogue. During this time, issuers may seek nonpublic treatment of offering documents, so long as all documents are publicly filed within 21 days of qualification.

Issuers conducting a Tier 1 offering will engage in back-and-forth discussions with the SEC as well as the states in which the offerings will be made. Tier 1 issuers will generally be required to go through the North American Securities Administrators Association's (NASAA) coordinated review process. In this review process, NASAA selects a lead examiner[4] who reviews a Reg A+ offering and solicits input from supporting examiners in other states. NASAA's coordinated review process has strict timelines. Issuers must receive a deficiency letter from the lead examiner (with input from all of the relevant states) within 21 business days of filing. Additionally, when an issuer files a response to a deficiency letter, the lead examiner must reply within 5 business days. Issuers conducting a Tier 2 offering will engage in discussions with the SEC without input from state regulators. The SEC does not have a strict response time requirement.

In 2016, the median number of days to qualify an offering statement was 68 days for Tier 1 and 104 days for Tier 2. The average number of days to qualify was 93 days for Tier 1 and 121 days for Tier 2.

## Step 5: Testing the Waters

This step is entirely optional and could potentially be placed at Step 3. Reg A+ is unique among other offering exemptions and public offerings in that it allows issuers to test the waters prior to and during the qualification process. Testing the waters materials used prior to filing an offering statement must be included as an exhibit upon filing. Testing the waters materials utilized after the filing of an offering statement must be accompanied by a preliminary offering statement or contain certain legends linking potential investors to the most recent version of the issuer's offering statement. Testing the waters materials that are used after the filing of an offering statement must also be included as an exhibit in the final offering statement. Testing the waters materials must contain risk disclosures and are subject to antifraud and civil liability laws.

The testing the waters rules are unique to Reg A+, but many issuers do not elect to utilize this ability for practical reasons. There is evidence to suggest this number may actually be lower now,

[4] A Tier 1 Reg A+ offering may actually have two lead examiners. While most states and the SEC conduct a review for adequate disclosure, some states conduct a merit review. In merit review states, the examiner will review an offering to determine whether, the administrator's view, an offering would be unfair, unjust, or inequitable. If an issuer applies for qualification in such states, there will be a lead disclosure examiner and a lead merit examiner.

but in 2016 only approximately 19% of issuers took advantage of the testing the waters capabilities (4% of Tier 1 and 33% of Tier 2). For Tier 1 offerings, the SEC's testing the waters rules do not preempt state solicitation requirements, which means Tier 1 issuers must comply with each state's solicitation rules. Doing so may be impractical, which could explain the low level of utilization for Tier 1 offerings.

In its discussion regarding the rollout of Reg A+, the SEC confirmed that discussion of factual business information, such as factual information about the issuer, its business, or financial developments, as well as advertisements concerning the issuer's products or services, does not constitute a solicitation of interest or testing the waters. This stance is consistent with Rule 169 of Sections 2(a)(10) and 5(c) of the Exchange Act.

## Post-Qualification Considerations

### Notice Filing

While Tier 2 offerings preempt state qualification, issuers must still notice file in each state in which they intend to offer their securities. While states may not impose additional disclosure or review requirements for Tier 2 offerings, the notice filing requirements vary from state to state in terms of filing forms, timing considerations, and filing fees. While some states do not impose a filing fee for notice filings, other states may require a notice filing fee in excess of $1,000. The cost and time associated with notice filing with each state must be included in the issuer's budgeted expenses.

### Ongoing Reporting

*FORM 1-K*

Tier 2 issuers are required to file annual reports on a Form 1-K within 120 calendar days after the end of each fiscal year. Form 1-K is split into Part 1 and Part 2.

Similar to Part 1 of Form 1-A, Part 1 of Form 1-K is the notification filing. Part 1 is an online form that issuers can fill out at the time of submission.

Similar to Part 2 of Form 1-A, Part 2 of Form 1-K constitutes the majority of the information about the issuer and the offering. Form 2 of Form 1-K must be provided electronically as a text file compatible with EDGAR. Part 2 of Form 1-K requires the disclosure of information about the business and upholds the narrative disclosure requirements that issuers are required to provide in Form 1-A. Some topics that must be covered include:

- Business operations of the issuer for the prior three fiscal years (or, if in existence for less than three years, since inception);
- Transactions with related persons, promoters, and certain control persons;
- Beneficial ownership of voting securities by executive officers, directors, and 10% owners;

- Identities of directors, executive officers, and significant employees, with a description of their business experience and involvement in certain legal proceedings;
- Executive compensation data for the most recent fiscal year for the three highest paid executive officers or directors;
- MD&A of the issuer's liquidity, capital resources, and results of operations covering the two most recently completed fiscal years; and
- Two years of audited financial statements.

*FORM 1-SA*

Tier 2 issuers must also provide semiannual reports via Form 1-SA within 90 calendar days after the end of the first six months of the issuer's fiscal year. Form 1-SA is an attenuated filing in comparison to Form 1-K and Form 1-A. While issuers are required to provide MD&A and updated financial statements, issuers are not required to update risk factors or provide audited financials.

*FORM 1-U*

Tier 2 issuers may also have to provide Form 1-U current reports. Some events that require a Form 1-U filing include:

- A fundamental change in the nature of an issuer's business includes major and substantial changes in the issuer's business or plan of operations or changes reasonably expected to result in such changes, such as significant acquisitions or dispositions, or the entry into, or termination of, a material definitive agreement that has or will result in major and substantial changes to the nature of an issuer's business or plan of operations;
- Bankruptcy or receivership;
- Material modification to the rights of securityholders;
- Changes in the issuer's certifying accountant;
- Non-reliance on previous financial statements or a related audit report or completed interim review;
- Changes in control of the issuer;
- Departure of the principal executive officer, principal financial officer, or principal accounting officer; and
- Unregistered sales of 10% or more of outstanding equity securities.

*FORM 1-Z*

Both Tier 1 and Tier 2 issuers will likely be required to file a Form 1-Z exit report with the SEC. Although Tier 1 issuers are not generally subject to ongoing reporting requirements, Tier 1 issuers must file a Form 1-Z with 30 calendar days after the termination or completion of the offering. Tier 2 issuers can file a Form 1-Z to stop ongoing reporting obligations any time after completing reporting for the fiscal year in which the offering statement was qualified, so long as the securities of each class are held by fewer than 300 persons and sales of the underlying securities are no longer ongoing.

Similar to Part I of Form 1-A and Part I of Form 1-K, Form 1-Z is an XML based form that can be filled out by the issuer upon filing. Form 1-Z contains information about the offering including the number of securities sold, the names of service providers and any fees they received, and net proceeds to the issuer. Tier 2 issuers that are seeking to suspend ongoing reporting requirements must also provide information that includes:

- Disclosure of the approximate number of holders of record of each class of securities the issuer has offered in Tier 2 offerings;
- A certification that the issuer has met all of the conditions for terminating its ongoing reporting obligations under Reg A+; and
- If it has not previously been provided, information about a previous Reg A+ offering that would be required in a Tier 1 exit report on Form 1-Z.

## Advertising

One advantage that Reg A+ has over other offering exemptions is that Reg A+ gives issuers the ability to freely advertise without losing or otherwise jeopardizing the exemption. Additionally, unlike a registered offering, there is no quiet period in a Reg A+ offering. Reg A+ issuers can advertise before, during, and after qualification.

Although issuers will generally file proposed solicitation material as an exhibit with the offering circular, the SEC does not require the filing of solicitation material for post-qualification Tier 2 issuers. The SEC considers the anti-fraud civil liability rules a sufficient deterrence against fraudulent or misleading advertising by Tier 2 Reg A+ issuers. Although post-qualification Tier 2 Reg A+ issuers should include sufficient disclaimers and avoid misleading language, so long as investors receive a copy of the qualified offering statement prior to investing, the issuers will be in compliance with the advertising requirements of Reg A+.

The SEC permitted states to retain more control over Tier 1 issuers. Depending on the state in which a Tier 1 issuers conducts its offering, Tier 1 issuers might be required to file solicitation material prior to deploying said material in the state. Some states may only require disclosure of marketing materials while others may conduct a merit review of marketing material. Tier 1 issuers should have an understanding of the solicitation material laws in each jurisdiction in which they intend to offer securities.

## 12(g) Conditional Exemption

Section 12(g) of the Exchange Act requires that issuers with (i) assets in excess of $10 million and (ii) a class of 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. Registering a class of securities with the SEC is a substantial undertaking, and the primary reason Reg A+ is in existence is to exempt startup and emerging issuers from having to undergo the onerous and cumbersome registration process.

In response to this concern, the SEC included a provision that exempts issuers from Section 12(g) of the Exchange Act provided the issuers:

- Stay current in advertising requirements;
- Engage the services of a transfer agent that is registered with the SEC; and
- Have a public float of less than $75 million in the most recent semi-annual period or, if the issuer does not have such a float, annual revenues of less than $50 million in the most recently completed fiscal year.

While it is doubtful that most Reg A+ issuers will exceed these requirements in their first few years of operations, issuers that do exceed these requirements will be granted a two-year transition period to comply with Section 12(g), which should allow issuers to develop a plan of action for further capital raising.

## Resale/Secondary Sales

While Reg A+ issued securities are not restricted securities, the SEC's focus on Reg A+ is more about providing capital for early stage investors and access to investments in emerging companies for non-accredited investors, as opposed to providing immediate liquidity to Reg A+ securities (a registered offering accomplishes this goal much more simply). In the 12 months following qualification, secondary trading is capped at $6 million for Tier 1 offerings and $15 million for Tier 2 offerings. Additionally, secondary sales by affiliates of the Reg A+ company may not account for more than 30% of the total dollar amount of the Reg A+ offering.

After the first-year ends, secondary sales by non-affiliate investors are capped at the maximum offering amount for Reg A+ offerings ($20 million for Tier 1 and $50 million for Tier 2).

Tier 1 issuers must be compliant with blue sky laws in the initial offering and in secondary sales. This is handled through the coordinated review process. Tier 2 offerings, however, are exempt from blue sky laws in the initial offering but may be subject to blue sky laws in secondary trading. There are some exemptions that would exempt a Tier 2 issuer from blue sky law requirements.

### *RULE 15C2-11 BROKER-DEALER SALES*

Exchange Act Rule 15c2-11 prohibits broker-dealers from publishing quotations (or submitting quotations for publication) in a "quotation medium" for covered over-the-counter securities without first reviewing basic information about the issuer, subject to certain exceptions. The SEC ruled that an issuer's ongoing Tier 2 reports will satisfy the specified information that a broker-dealer must review before publishing a quotation for a security, thus allowing sale of Tier 2 securities through broker-dealer exemptions.

### *RULE 144 AND 144A*

Rule 144 provides a safe harbor for the resale of restricted and control securities. Rule 144A provides a safe harbor for resales of unregistered securities that meet specific requirements.

Both Rule 144 and Rule 144A require "reasonably current information" concerning the issuer. In discussing Reg A+, the SEC stated that semiannual reporting does not constitute reasonably current information. Instead, issuers that utilize Rule 144 or Rule 144A for secondary sales of securities must voluntarily provide quarterly information on a Form 1-U in order to satisfy the "reasonably current information" requirement.

*ALTERNATIVE TRADING SYSTEMS AND EXCHANGE OFFERINGS*

Reg A+ issuers can also qualify for blue sky exemptions by trading on alternative trading systems such as OTCQX and OTCQB. OTCQX has higher compliance requirements than OTCQB. In order to apply for consideration, OTCQX requires issuers to be current in Tier 2 ongoing disclosure requirements, annually audited by a PCAOB-registered auditor (there is no PCAOB requirement in Reg A+), and file quarterly financials under Form 1-U. OTCQB is catered towards growth and venture stage companies. To apply for consideration, OTCQB requires issuers to be current in Tier 2 ongoing disclosure requirements and meet OTCQB continuing disclosure standards.

Tier 2 issuers may also list on national securities exchanges such as NASDAQ and the NYSE, although issuers will likely need to meet higher disclosure and registration requirements. For example, they may be required to comply with general Exchange Act requirements, such as filing a Form 8-A alongside an offering registration, following Form S-1 or Form S-11 for Form 1-A, and obtaining audited financials from a PCAOB-registered auditor that is independent pursuant to Regulation S-X. In addition, national securities exchanges will likely impose their own standards regarding issuer size, liquidity, and corporate governance criteria.

## Conclusion

Reg A+ is a less burdensome and time-consuming approach to the Registered IPO model. It can provide issuers with increased flexibility to raise capital and further innovation. While more time is required in order to fully assess the success of Reg A+, nearly four years after its creation, Reg A+ is quickly becoming a valuable capital raising tool for startup and emerging companies.

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## *About Cole-Frieman & Mallon LLP*

Cole-Frieman & Mallon LLP is a premier boutique law firm, providing top-tier, responsive, and cost-effective legal solutions for a wide range of financial services matters, including alternative investment vehicle formation and administration, regulatory inquiries, and exempt securities offerings. You can find more information regarding the firm at www.colefrieman.com.

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