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NEWS RELEASE – NEW REGULATION A - CRITICAL COMMENTARY TO THE SEC

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On December 18, 2013, the United States Securities and Exchange Commission ("SEC") proposed landmark rules, pursuant to the mandate of Title IV of the Jumpstart Our Business Start-Ups Act (the "JOBS Act"), to revitalize Regulation A promulgated under Section 3(b) of the Securities Act of 1933, as amended (the "Securities Act"). These rules create a create a two-"Tier" system for Regulation A offerings. Tier 1 will continue to be available for offerings under $5 million, while a Tier 2 Regulation A offering will be for offerings of up to $50 million. Tier 1 offerings will continue to have similar requirements as existing Regulation A, while an issuer conducting a Tier 2 offering will be subject to heightened disclosure requirements in its offering documents and will be required to make ongoing reporting.

The proposed rules and accompanying SEC proposing release (the "Proposing Release") are voluminous, containing over 130 separate requests for comment and are currently in the public comment period. This article presents critical areas of the proposed rules where KVCF believes the utility of revised Regulation A could be significantly affected by SEC's final rules and arguments related to the same. KVCF urges issuers, prospective issuers, sponsors, broker-dealers and other industry participants to comment to SEC regarding these inflection points as set forth in this article.

1. ***State Preemption***

   Title IV of the JOBS Act ("Title IV") preempts state regulation of Regulation A securities that are: (i) listed on a national securities exchange; or (ii) sold to "qualified purchasers" as defined by the SEC. SEC has defined "qualified purchaser" in the proposal as all offerees of securities in a Tier 1 offering and all offerees and purchasers in a Tier 2 offering. However, the definition does not apply to resale.

   State securities regulation has been one of the two largest obstacles inhibiting the usage of Regulation A (the other being the former limit of $5 million in offering size), and so state preemption is a critical element of a workable Regulation A solution. The Government Accountability Office ("GAO") found precisely the same when, in its study of Regulation A required under the JOBS Act, GAO indicated that state securities regulation was a factor contributing to Regulation A's lack of usage.[1]

[1] See also, Testimony of Robert R. Kaplan, Jr., before the Senate Subcommittee for Securities, Insurance and Investment Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs at http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.LiveStream&Hearing_id=c2fe9f9a-0e5e-4b44-a566-4a8cef26c06e.

Issuers, prospective issuers, sponsors, broker-dealers and other industry participants should comment strongly in favor of this definition. For the reasons stated above state preemption is a integral piece of making this an efficient and workable means of forming capital and a market with sufficient size so that the advantages of Regulation A can be realized fully. Second, investor protections are not hampered. The law limits the amount that an investor can place in a given offering as discussed below, and the state regulatory agencies will have full access to the offering disclosure and ongoing reporting of the issuers conducting Tier 2 offerings. They can monitor this activity in a manner which does not overly constrain capital formation (contrary to Congress's intent) intended to create jobs and protect the public accordingly. State preemption only obviates the ability of merit review states to impose arbitrary requirements on an issuer or the offering structure which may not be, and often are not, applicable in a given context.

Furthermore, in light of a key feature of Regulation A securities being their unrestricted nature, commentators should consider whether to urge SEC to apply the definition to resales of Regulation A securities where issuers that are up-to-date in their reporting requirements. While not fatal to a secondary market, the complications presented by having to ensure that resale complies with applicable state law could slow the development of an active secondary market, as intended by Title IV.

The issue of State preemption is shaping up to be the top issue related to the Proposing Release, with States and NASAA already putting immense pressure on SEC to reverse course. The private market should provide its insights to the SEC, letting them know the practical realities of the current state regulatory regime and the need to streamline the offering process.

2. The 10% Cap on Investment in Tier 2 Offerings

As proposed, a prospective investor's maximum investment in any individual Tier 2 offering would be capped at an amount equal to the greater of 10% of the investor's net worth and annual income. Industry participants should understand that this 10% cap, as proposed, is applicable to offerings on an individual basis, not in the aggregate. However, SEC has requested comment as to whether the investment cap should be applied on an aggregate basis across all Tier 2 offerings in which an investor may participate.

The 10% cap on investment in an individual offering strikes the appropriate balance between investor protection and capital formation. An aggregate cap on Tier 2 investments is not a necessary or appropriate investor protection. While the individual offering cap can help protect investors from the downside risk associated with investing in smaller companies by forcing investment diversification, the aggregate cap could serve to prevent that very same diversification into other Tier 2 offerings. Tier 2 offerings, and Regulation A in general, if successfully transformed into the viable, vibrant exemption intended by the JOBS Act, can offer smaller investors opportunities that were previously only available to those meeting accredited investor status and KVCF does not believe SEC should limit those opportunities with an aggregate cap.

Another critical feature of the 10% cap is the method by which an issuer must verify each investor is not exceeding his or her cap. The current proposal, which KVCF strongly supports,

permits issuers to rely on representations made by the prospective investor as to his or her income and net worth, unless the issuer knows that the prospective investor's representations are untrue. This proposal is in marked contrast to the "reasonable investigation" requirements of Rule 506(c) for verifying the accredited status of investors in a public offering under Rule 506 of Regulation D. SEC has solicited comment as to whether additional verification steps should be required of issuers in Tier 2 offerings. As SEC alludes in the Proposing Release, there are investor privacy and practical concerns with requiring additional verification of investor information in a Tier 2 offering. We concur with the SEC on this front.

For the above mentioned reasons, we believe it is in the interest of issuers, prospective issuers, sponsors, broker-dealers and other industry participants to comment in favor of the 10% investment limitation and attendant verification requirements as proposed.

3. Potential Limitation to Operating Companies

Regulation A has a long history of excluding certain types of issuers, including investment companies and issuers of fractional interests in oil and gas or other mineral rights.[2] SEC has solicited comment regarding potential expansion of the Regulation A exclusions to any issuer who is not an "operating company." While SEC has not laid out a specific definition of "operating company", in the Proposing Release SEC indicates that any such definition would be expected to exclude "those enterprises with the principal business of investing or reinvesting funds in securities, properties, commodities, business opportunities or similar media of speculative opportunity" from reliance on Regulation A.

The formation of capital, whether directly by operating companies, or by enterprises that invest or reinvest the funds, leads to job creation. Therefore, issuers, prospective issuers, sponsors, broker-dealers and other industry participants to comment to SEC that use of Regulation A not be restricted to use by operating companies.

4. Application of Section 12(g) of the Securities Exchange Act of 1934

Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended by Title V of the JOBS Act ("Title V"), provides that any company with more than $10 million in assets and a class of equity securities held of record[3] by either (i) more than 2000 persons or (ii) more than 500 persons who are not accredited investors, must register and report under the Exchange Act.

SEC should dispense with the cap of 500 non-accredited investors for purposes of issuers making Tier 2 offerings who are current in their reporting as required by new Regulation A. Accreditation is not required to purchase securities in a Regulation A offering. There does not appear to be any logical reason for why this would matter in the after market. Furthermore, Regulation A issuers may choose not to access capital through broker-dealers, or may access it

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[2] KVCF believes that the current exclusions should be maintained as proposed; provided that, KVCF believes that Business Development Companies ("BDCs") should be permitted to utilize Regulation A, despite their regulation under the Investment Company Act of 1940. BDCs invest in the types of companies that stand to benefit the most from new Regulation A and, therefore, permitting BDCs themselves to rely on Regulation A will serve Congress's intent under Title IV.

[3] In many cases, Regulation A securities, especially in Tier 2 offerings, will be held in street name by broker-dealers participating in the offering, or any secondary market that may develop, and therefore the beneficial holders of those securities would not hold them "of record" for purposes of counting toward the Section 12(g) thresholds.

through broker-dealers unwilling or unable to hold securities on behalf of their clients. In these cases, the 500 non-accredited investor cap could have a chilling effect on such an issuer's capacity to raise capital in a Tier 2 offering. In a $50 million dollar Tier 2 offering or even in Tier 2 offerings of significantly less than the maximum, an issuer would be required to sell a significant portion of the offering to accredited investors because the proposed 10% investment limitation would cap the amount a non-accredited investor could put into a Tier 2 offering at less than $100,000. The 500 non-accredited investor threshold should not be applied in respect of the holders of Tier 2 securities, as long as the issuer of such securities is current in its reporting. KVCF urges issuers, prospective issuers, sponsors, broker-dealers and other industry participants to take a like position in commentary to SEC.

5. Implications of Tier 2 Reporting: Exchange Act Rule 15c2-11 and Securities Act Rule 144

The reporting requirements for the issuers in Tier 2 offerings will help open significant liquidity opportunities to those who remain current in their reports. Rule 15c2-11 under the Exchange Act sets various types of information regarding an issuer of which a broker-dealer must have reviewed and retained at least one before publishing quotations regarding that issuer's securities in the over-the-counter markets. SEC has proposed that the reports required of issuers in a Tier 2 offering will qualify as adequate information under Rule 15c2-11. This proposal is critical to the development of a viable secondary market, so all market participants with an eye on Regulation A should strongly support SEC in this respect.

SEC has solicited comment on whether Rule 144 promulgated under the Securities Act should be amended to include reporting under Tier 2 in the categories of publicly available information for a non Exchange Act reporting issuer that will allow such an issuer's securities holders to rely on Rule 144 to sell their otherwise restricted securities to the public. This makes logical sense as the Tier 2 reports will contain substantially all of the public information enumerated in Rule 144 for non-reporting issuers. If SEC ultimately proposes and adopts this potential change, it will represent an opportunity for issuers to provide liquidity for the holders of their restricted securities without submitting to the full Exchange Act reporting regime. Such an issuer could engage in a Tier 2 Regulation A offering (of which up to $15 million may be direct resales of the issuer's previously issued securities) and then by virtue of making the reports, provide liquidity under Rule 144 to any securities holders not selling in the Tier 2 offering. All issuers, prospective issuers, sponsors, broker-dealers and other industry participants should comment to the SEC in support of this opportunity to further enhance liquidity through Regulation A.

KVCF's goal is to make Regulation A a viable, vibrant piece of the United States capital markets puzzle. The proposed rules are a great first step to doing so, and we believe with the support of other industry participants on critical inflection points, like those outlined above, SEC will not stumble when finalizing new Regulation A.