Article

Wednesday, April 11, 2012

KAPLAN VOEKLER CUNNINGHAM & FRANK, PLC

Regulation A: Old Reg, New Opportunity

For the last 30 years, Regulation D has dominated the exempt securities offerings landscape. This dominance was only enhanced with the passage of the National Securities Markets Improvement Act of 1996 (NSMIA) which exempted from state securities regulation (or "Blue Sky") securities sold in offerings made pursuant to Rule 506 of Regulation D. In the aftermath of the recent economic and financial crisis two leading factors have emerged to hobble the usage of Rule 506 for most issuers in the raising of capital: (i) the lack of liquidity of Rule 506 securities, and (ii) changes to the definition of "accredited investor" in the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") signed into law by President Obama in July 2010.

Securities sold pursuant to Regulation D are, generally, "restricted securities." They cannot be resold by an investor without either registering the securities to be sold or finding an exemption from registration. These legal limits on the tradability of these securities have forced many investors to ride failing investments through the economic crisis. As a result investors have soured on investments lacking at least notional liquidity. In addition, broker-dealers face increasing headwinds from their insurance providers related to selling restricted securities.

In 2012, Dodd-Frank significantly reduced the size of the available "accredited investor" pool qualified to invest in theses securities. Dodd-Frank effected a change to the most prominent category of "accredited investor", individuals (or married couples jointly) with a net worth of over $1 million, by requiring that the value of a person's primary residence be excluded from the calculation of net worth. Estimates of the effect this change had on the accredited investor pool range from reductions of 10% up to 30%, but there is no question it has reduced demand for securities offered pursuant to Regulation D. As such, small businesses, investment sponsors, broker-dealers, legislators and regulators have all begun to seek alternatives for raising capital. One such alternative is Regulation A, which finds its roots in regulations promulgated by the SEC in the 1930s.

Regulation A is promulgated under Section 3(b) of the Securities Act of 1933 ("Securities Act") which, as currently written, permits the Securities and Exchange Commission ("SEC") to exempt classes of securities from registration provided that the dollar amount of securities that may be issued pursuant to a Section 3(b) exemption may not exceed $5 million in any one year. Regulation A exempts the securities from registration whereas Regulation D requires the offering to be private and remain private to be exempt.

Therefore, Regulation A currently has three significant advantages over Regulation D offerings: **(i) general, public solicitation is permitted*,**

*The JOBS Act discussed below directs the SEC to change Rule 506 to permit public solicitations of securities ultimately sold only to accredited investors.

(ii) the securities are freely tradeable (<u>not</u> restricted) and (iii) the securities may be marketed to non-accredited investors. The last two of these factors specifically and favorably address the preeminent issues in today's Regulation D marketplace making a Regulation A offering attractive for an issuer willing and able to invest a little more time and effort into its offering.

While completing the Regulation A process with the SEC can be considered a "mini-registration," the filings are fundamentally simpler in form than public registration, including far less taxing accounting requirements. Regulations S-K and S-X generally do not apply.

In comparison to registration under the Securities Act, Regulation A truly shines with respect to the burdens placed on an issuer following SEC approval of its offering. While a registration under the Securities Act triggers ongoing reporting requirements under the Exchange Act of 1934 and costly compliance requirements pursuant to the Sarbanes-Oxley Act, at the federal level qualification of an offering pursuant to Regulation A triggers only minor reporting requirements regarding the use of the offering's proceeds.

It is not just issuers, broker-dealers, their counsel and other players in the capital markets who have begun to recognize this potential. The United States Congress recently passed the Jumpstart Our Business Startups Act, or "JOBS Act" with overwhelming bipartisan support. President Obama signed the JOBS Act into law on April 5, 2012. Title IV of the JOBS Act entitled "Small Company Capital Formation" ("Title IV") encapsulates without change the Small Company Capital Formation Act originally proposed and sponsored in the U.S. House of Representatives by Representative David Schweikert (R-AZ).

Title IV amends Section 3(b) of the Securities Act to direct the SEC to increase the amount to be sold under Regulation A from $5 million to $50 million in a 12-month period. Title IV instructs that the securities exempted may be offered and sold publicly, that they will not be restricted securities (ie. they will be freely tradable), and that the issuer of the securities must file audited financials with the SEC annually. Title IV also invites the SEC to bring Regulation A into the 21st century by requiring electronic, as opposed to the current paper filings, and it invites the SEC to require periodic disclosures in addition to the annual filing of audited financial statements.

The enactment of the JOBS Act will not immediately result in an increased Regulation A threshold because the SEC must first promulgate revisions to Regulation A creating the new class of exempt securities. The best estimate the SEC's Office of Small Business Policy has been able to give us is that implementation of the regulations required by Title IV will take a minimum of six months, but even that is very preliminary and subject to change.

For now and the foreseeable future, Regulation A securities must be registered or seek a specific exemption in each state in which they will be offered. Savvy issuers, underwriters and their counsel can successfully ameliorate the time and cost associated with state registration through two steps. First, issuers and their underwriters should carefully examine where they believe they will sell the offered securities, and limit the offering to only those states. Second, careful attention must be paid to technical requirements of a registration (or exemption) in the states selected in order to ensure that the offering structure and disclosure documents elicit a minimum of comments.

Congress is also aware of the potential difficulties posed to Regulation A offerings by state Blue Sky Laws, and, therefore, Title IV requires the Comptroller General to conduct a study of the impact of the state securities laws on Regulation A offerings and report back to the House and Senate within three months of the enactment of the JOBS Act. Based on conversations with the SEC, we consider it unlikely that Regulation A securities will receive federally covered status as a general proposition, outside of sales on national exchanges or to qualified purchasers in the near future; however, a uniform state registration process (similar to NASAA's coordinated equity program for federally registered offerings) may result from the required study.

Despite this, Regulation A is a viable alternative for raising capital, and the JOBS Act will only accelerate and accentuate the emergence of Regulation A from Regulation D's shadow for small business and investment program sponsors alike. Regulation A may yet become the "magic bullet" for capital formation.

Kaplan Voekler Cunningham & Frank PLC

Richmond Office | 7 East 2nd Street | Richmond, VA 23224 | Phone: 804.423.7921
Northern Virginia Office | 439 North Lee Street | Alexandria, VA 22314 | Phone: 572.527.1300
Houston Office | 395 Sawdust Road, Suite 2137 | The Woodlands, TX 77380 | Phone: 281.702.2137