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A Regulation A+ Primer

Regulation A has labored in obscurity for more than 50 years, an unsightly and forgotten understudy to glamorous headliners like Rule 506. All that changed March 26, 2015, when Regulation A, draped in finery and even given a new name boasting its excellence, stepped into the spotlight, cameras clicking and flashbulbs popping.

In the Regulation A+ Primer, I hope to provide practical guidance on the new star of the Crowdfunding universe.

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Why It Matters

Regulation A+ allows issuers to raise up to $50 million per year from both accredited and non-accredited investors at a reasonable cost, using the Internet. That's a big deal!

By opening the door to tens of millions of additional potential investors, Regulation A+ also promises to transform the entire Crowdfunding ecosystem in ways that none of us can predict.

Who Can Use Regulation A+

Anyone can use Regulation A+ to raise money except:

- Foreign issuers (other than Canadians, who look and talk like Americans, except for a slight accent)
- U.S. or Canadian issuers whose principal offices are not in the U.S. or Canada

  EXAMPLE: The owner of NewCo, a Delaware corporation in the investment advisory business, has grown tired of New York winters and moves the offices of the corporation to the south of Spain. NewCo can no longer use Regulation A+ to raise money, although that doesn't bother the owner.

- Investment companies, as defined in the Investment Company Act of 1940

  EXAMPLE: Following the model often used in Title II Crowdfunding, the sponsor of HiTech, LLC, an operating company, forms InvestCo, LLC to raise money. InvestCo's only asset is stock in HiTech. If InvestCo has more than 100 shareholders (with obscure exceptions) it's an investment company and can't use Regulation A+ (and might even need to register under the '40 Act!).

  EXAMPLE: Suppose InvestCo in the example above has only 85 shareholders. It still can't use Regulation A+, because the exemption under the Investment Company Act is not available to issuers who have engaged in a "public offering."

- Reporting (public) companies

  EXAMPLE: Company X was a reporting company, but has voluntarily and legally de-registered and is no longer required to report under section 13 or 15 (d) of the Exchange Act. Company X may use Regulation A+.

- A development stage company that has no specific business plan or purpose, or has indicated that its business plan is to merge with or acquire an unidentified company or companies

  EXAMPLE: Sponsor Smith wants to raise $50 million to invest in real estate in Toronto. No problem. That's not "a development stage company that has no specific business plan."

- A company issuing fractional undivided interests in oil or gas rights, or a similar interest in other mineral rights
- Companies disqualified under the "bad actor" rules

Why Use Regulation A+

As a *company*, you should consider Regulation A+ if you want to raise money from non-accredited investors.

There are two reasons for raising money from non-accredited investors. One reason is that non-accredited investors have money, just like regular people. The other reason is less tangible, but sometimes even more important.

If you are a developer building a project in an urban neighborhood, for example, there are several benefits to including neighbors among your investors, even if their money contributions are relatively modest:

- They support your project through the approval process
- They provide valuable information about the kind of project you should build
- They patronize the commercial establishments in your project
- They provide a built-in support system, allowing you to command higher rents

The same kinds of benefits are available to a biotech company raising money from anyone touched by diabetes, where potential investors might provide valuable feedback about the science and the potential market.

In both cases, the ability to reach non-accredited investors creates a symbiotic relationship between the entrepreneur and her investors where the real magic of Crowdfunding kicks in.

As the *owner* of a company, you should consider Regulation A+ if you want to raise money for the company and at the same time sell some of your own shares.

Why Not Use Regulation A+

Cost:

A Regulation A+ offering will cost a lot more than a Title II offering. Apples to apples, the cost difference could be:

	To Conduct Offering	*Annual Reporting Cost*
Regulation A+	$75,000*	$20,000*
Title II	$5,000 - $10,000	$0

*Depends on cost of financial audit

Time:

We can kick off a Title II offering in a week. At least initially, a Regulation A+ offering could take six months.

Confidentiality:

Regulation A+ requires highly granular disclosures, very similar to a public offering, and the filings are public. An issuer with a confidential business idea might not like the idea of sharing her idea with the whole world.

A few reasons not to worry too much about confidentiality, however:

- A business idea that is patented is protected, even if everyone knows about it
- Not everything has to be disclosed. If you've invented a new soft drink, the formula remains secret
- Entrepreneurs typically over-estimate the value of their idea. It's normally not the idea that creates all the value, it's the *execution* of the idea

  EXAMPLE: Howard Schultz, the founder of Starbucks, had an incredibly novel idea that made him a billionaire: selling coffee.

Paternalistic Regulatory Scheme:

A Regulation A+ offering has more in common with a public offering than with a private offering. An entrepreneur or developer used to raising money privately, or through Title II Crowdfunding, could feel as if he's stepped into an interrogation room with bright lights.

EXAMPLE: Real estate developers typically earn fees from the projects they sponsor - acquisition fees, management fees, brokerage fees, and so forth. In a Regulation A+ offering, expect the SEC to comment on and possibly reduce or prohibit some of these fees.

EXAMPLE: In most Title II offerings, the governing documents limit the liability of the sponsor to some degree, even going so far as to eliminate the sponsor's fiduciary obligations altogether. The SEC might look unfavorably on those kinds of limitations.

EXAMPLE: Crowdfunding Portal X creates a fund to invest in biotech companies. If Portal X raises money using Regulation A+, the SEC will want lots of detail about how investment decisions will be made.

Alternatives to Regulation A+

If you don't need non-accredited investors, don't use Regulation A+. Use Title II Crowdfunding instead.

If you need non-accredited investors and live in a state with intrastate Crowdfunding, think about that.

If you need non-accredited investors and don't live in a state with intrastate Crowdfunding, or can't satisfy the rules of your state's rules, but can limit your offering to one or two states, think about Tier 1 before going to Tier 2.

Eligible Securities

You can sell just about any kind of security using Regulation A+. Under Regulation A+ you can sell equity securities, debt securities, and debt securities convertible into equity securities. You can sell securities of corporations and securities of limited liability companies and limited partnerships.

But you can't use Regulation A+ to sell an "asset-backed security," meaning "a security primarily serviced by the cash flows of a discrete pool of receivables or other financial assets."

> **EXAMPLE**: You can't securitize credit card debt using Regulation A+.
>
> **EXAMPLE**: You plan to sell borrower-dependent notes using Regulation A+. That's okay, because each borrower-dependent note is backed by a *single* underlying obligation, not by a "pool" of assets.
>
> **EXAMPLE** A REIT can use Regulation A+.

The Right Structure for a Regulation A+ Offering

An issuer selling securities under Regulation A+ will admit investors directly into its own cap table, with no intermediaries.

In Title II, we often form a separate company to "hold" Crowdfunding investors:

> **EXAMPLE**: HiTech, LLC, an operating company, wants to raise $1 million from accredited investors using Title II Crowdfunding. Rather than admit investors to its own cap table, HiTech forms InvestCo, LLC, a special purpose vehicle. Investors buy interests in InvestCo, and InvestCo holds a special class of stock of HiTech. That way, HiTech admits only one investor (InvestCo) to its own cap table.

That strategy has worked, by and large, in Title II Crowdfunding. But it won't work with Regulation A+ - or not as easily - because InvestCo will be treated as an "investment company" subject to the regulatory headaches associated with the Investment Company Act of 1940.

The good news is that admitting investors to the issuer's cap table really isn't such a bad thing. Almost anything we could accomplish using a SPV we can also accomplish by issuing a special class of stock to Regulation A+ investors.

Tier 1 and Tier 2

Within Regulation A+ there are two kinds of offerings: Tier 1 offerings and Tier 2 offerings. Different rules apply to each Tier.

Tier 1 is mainly the old Regulation A, but with the offering limit increased from $5 million to $20 million. All the new stuff - specifically the state preemption - is in Tier 2.

An issuer raising $20 million or less can *elect* whether to use Tier 1 or Tier 2. Although most issuers will choose Tier 2 because of the state preemption, an issuer raising money in only one or two states might choose Tier 1 because:

- Tier 1 doesn't require audited financial statements
- Tier 1 doesn't limit the amount that can be invested by a non-accredited investor (neither Tier 1 nor Tier 2 limits that amount that can be invested by an accredited investor)
- Tier 1 doesn't require ongoing reporting

Offering Limits

An issuer can raise $20 million under Tier 1, $50 million under Tier 2.

The offering limits are *per issuer.*

> **EXAMPLE**: Issuer X raises $30 million for Project A. Within the same 12 month period, Issuer X can raise only $20 million for Project B.

The offering limits apply to *12 month periods*.

> **EXAMPLE**: Issuer X raises $30 million for Project A. Twelve months later, Issuer X can raise another $50 million for Project A, or for Project B.

The offering limits apply *only to money raised using Regulation A+* (Tier 1 or Tier 2).

> **EXAMPLE**: Issuer X raises $30 million for Project A using Tier 2 of Regulation A+. Tapping the overseas market, Issuer X can simultaneously raise $40 million from China for Project A using Regulation S.

The normal "integration" rules apply to money raised by affiliates of the issuer.

> **EXAMPLE**: Issuer X uses Regulation A+ to raise $30 million for Project A, a commercial development in Chicago. Within the same 12 months, Issuer Y, an affiliate of Issuer X developing a dating app for dog lovers, can raise $50 million using Regulation A+. When a second affiliate, Issuer Z, tries to raise $30 million within the same 12 month period to add a residential component to Project A, they're going to need to speak with a lawyer.

Given that issuers are pushing the upper limit of investor demand at $2 million in Title II Crowdfunding, I don't expect the $50 million cap to matter much initially. The SEC is required to review the limits every two years anyway, the first time in April 2016. If and when the $50 million cap starts to matter, the SEC can adjust it.

State Preemption

Apart from the new offering limits - $20 million under Tier 1 and $50 million under Tier 2 - the most important thing about Regulation A+ is that *Tier 2 offerings are not subject to state registration and merit review.*

> **EXAMPLE**: Issuer X, based in Illinois, wants to raise money from non-accredited investors in the Midwest and also in Texas, California, and New York. Under old Regulation A (and continuing in Tier 1), Issuer X was required to register with, and get the approval of, not just the SEC, but *every state where it raises money*. Under Tier 2 of Regulation A+, Issuer X is required only to register with and get the approval of the SEC.

State preemption is even more important than the offering limits. If issuers had to register with every state, as they did under old Regulation A, you could raise the offering limits to $100 million and it wouldn't do much good.

State preemption means that an issuer is not required to register with – and obtain the approval of – state securities regulators. However, state regulators retain the authority to:

- Investigate and prosecute securities fraud
- Require issuers to file any documents filed with the SEC
- Require issuers to consent to service of process and pay filing fees

NASAA, the National Association of Securities Administrators Association, absolutely hates state preemption. Their furious opposition is what delayed adoption of the final Regulation A+ rules, and they will likely file a lawsuit within the next several weeks alleging that the regulations are invalid because the SEC overstepped its bounds. Should that lawsuit be successful, state preemption would be back to square one.

Here's another twist. The NASAA recently launched a multi-state coordinated review program for Regulation A offerings. If that program works in practice the way it is supposed to work in theory – allowing an issuer to register with multiple states by filing just one package, with a quick turnaround time – it could make state preemption moot, thereby potentially making Tier 1 more attractive than Tier 2 (because of the lower cost) for most issuers.

That assumes, of course, that the states will be satisfied with the disclosure requirements of Tier 1. If states require audited financial statements for Tier 1 filers, for example, which is certainly their prerogative, it could flip the switch the other way.

The Approval Process - Estimate of Cost and Time

To sell securities under Regulation A+, the issuer must file a thick offering document with the SEC, starting with Form 1-A and adding other relevant information. But you don't just file and start selling. The filing must first be *approved* – or "qualified" to use the technical term – by the SEC. You file the thick document, the SEC reviews it and very likely has questions and comments, then you revise it, then the SEC might have more questions and comments, and so forth. You can't start selling until that process is complete and the SEC signs off.

There are two $50,000 questions:

- How long will the process take, start to finish?
- How much will it cost?

If you were starting a Regulation A+ offering today, you could complete the package by the time the regulations come into effect 60 days from now. Or more exactly, you could complete everything but the financial statements. The financial statements might take 60 days or they might take a lot longer, depending on whether they have to be audited and the size and financial complexity of the company. So that's one significant variable.

The other is how long the SEC will take to review the package. A few years from now, when the Republican Congress has provided money to hire more staff and things are running smoothly, you might get through the review process in as little as six weeks. In 2015, with an undermanned staff inundated with Regulation A+ filings, I expect it will take a lot longer than that. Three months? Four months? More?

In terms of cost, I estimate the legal fees to prepare and negotiate the disclosure package with the SEC will fall in the $35,000 to $50,000 range, at least initially. The cost of audited financial statements will vary widely. For a small startup you might get an audit for less than $10,000, while for a larger company with a more complex financial profile the cost could be many multiples of that.

Very roughly, a typical Regulation A+ issuer would probably be safe budgeting $75,000 and six months. As a big believer in technology and the power of innovation, I expect it won't be long before technology streamlines the filing process and drives down its cost significantly.

Generally speaking, documents filed with the SEC are public. However, an issuer that has not previously sold securities under either Regulation A+ or a public registration statement is allowed to file a "draft" offering statement with the SEC, which will be reviewed confidentially.

All filings will be electronic, via the EDGAR system, naturally.

Testing the Waters

You can't actually sell securities until the SEC has reviewed and approved your thick offering document. In the meantime, however, and indeed before your lawyer puts pen to paper, you can solicit expressions of interest from potential investors, a process often referred to as "testing the waters." By soliciting expressions of interest, you can see whether investors are interested before you spend a lot of money.

> **EXAMPLE**: A scientist at University X believes she's discovered a new therapy for cystic fibrosis. Working with the Cystic Fibrosis Foundation, she or the University may solicit its members, explaining the scientific advance and asking whether they would be interested in investing.

Just bear in mind that it's usually much easier to get a non-binding expression of interest from an investor (all expressions of interest must be non-binding) than an actual check. An issuer wanting to test the waters more effectively, and even to raise money for a Regulation A+ offering might be better off running a Kickstarter campaign or a limited Title II offering.

Any materials used to solicit expressions of interest must be filed with the SEC if the Regulation A+ offering goes forward. That's going to raise interesting questions for issuers: the website used to solicit interest will certainly be filed, but what about the email the CEO sent three days ago to a potential investor?

Financial Statements

Tier 2 issuers are required to provide two years of audited financial statements. For U.S. issuers the financial statements must be prepared in accordance with generally accepted accounting principles (GAAP) while for Canadian issuers the financial statements may be prepared in accordance with GAAP or with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

Tier 1 issuers are allowed to use only reviewed statements. However, if those statements are audited for other purposes, the audited version must be used.

Audited statements are much more expensive than unaudited statements. But an audited statement for a startup isn't nearly as expensive as an audited statement for an up-and-running operating company. I have heard quotes of as little as $5,000 for a startup.

I also expect that competition and technology will drive down the cost of audited statements, just as they will drive down legal fees.

Ongoing Reporting

Issuers in Tier 1 offerings are not subject to any ongoing reporting requirements except a Form 1-Z to report the completion of the offering.

The story is more complicated for issuers in Tier 2 offerings. Conceptually, the issuer is required to file:

- Annual reports, using Form 1-K, including information on business operations, related party transactions, beneficial ownership of voting securities, identification of directors, executive officers and significant employees, executive compensation data for the three most highly paid officers, a management discussion, and two years of financial statements
- Semiannual reports, using Form 1-SA, including (unaudited) interim financial statements and a management discussion
- Current event reports, using Form 1-U, reporting fundamental changes, bankruptcy or receivership, material modifications of the rights of security holders, changes in accountants, changes in control, departure of the principal executive, financial or accounting officers, unregistered sales of 10% or more of outstanding equity securities, and other significant events
- Other reporting, in some circumstances

However, those reporting obligations terminate if the Tier 2 issuer has fewer than 300 record holders of the class of securities offered, and there is no ongoing offering under Regulation A. If an issuer sells to fewer than 300 investors in the first place, which is likely to be the case for the first wave of Tier 2 filings, the ongoing reporting obligations disappear.

For an issuer with 300 or more record holders, the cost of annual reporting will be primarily a function of the audit cost. For a typical small company, the total cost might be in the range of $25,000.

Limits on Investment

Anyone can invest under Regulation A+, accredited and non-accredited, U.S. investors and non-U.S. investors.

In a Tier 2 offering of securities that will not be listed on national exchange, a non-accredited investor is limited to investing the *greater of* 10% of her annual income or 10% of her net worth, excluding her principal residence. That's a per-offering limit, not a per-investor limit.

> **EXAMPLE**: Non-accredited Investor Y earns $75,000 per year and has a net worth is $250,000. She may invest $25,000 in Company A, $25,000 in Company B, $25,000 in Company C, and so forth.

In the case of a non-accredited investor that is not a human being, the 10% limit is applied to revenue and net assets rather than to income and net worth.

Otherwise, there are no investment limits under Regulation A+. That is, no investment limits under Tier 2 for accredited investors, and no investment limits under Tier 1 for anybody.

Non-accredited investors are allowed to "self verify" their income and net worth by checking a box or filling out a form. The issuer is not required to verify independently.

In fact, an issuer raising capital under Regulation A+ is not required to independently verify that an investor who says she's accredited really is accredited. That's a big difference with Title II, where issuers are required to take "reasonable steps" to verify that investors are accredited.

Combining Regulation A+ With Other Offerings

Basic Rules

- You can raise money in the U.S. using Regulation A+ while at the same time raising money overseas using Regulation S.
- Should Title III ever become effective, you will be allowed to raise money using Regulation A+ while simultaneously raising money using Title III.
- You can start a Regulation A+ offering after a Title II offering is complete.
- You can start a Title II offering six months after a Regulation A+ offering is complete.

Combining Regulation A+ and Title II

Theoretically, it is possible to raise money using Regulation A+ while simultaneously raising money using Title II. Thank you, Sara Hanks of CrowdCheck, for pointing this out!

Doing so legally raises tricky questions, however, while the benefits are limited. Perhaps if your Regulation A+ offering were pushing against the $20 million or $50 million maximum, you would initiate a Title II offering to raise more money. But if you're not careful, your Title II offering could ruin your Regulation A+ offering and vice versa, earning you a place in the Crowdfunding Hall of Shame.

Integration of Offerings by Affiliates

Whether two ostensibly separate offerings should be treated as one is among the longest-running questions in securities law.

> **EXAMPLE**: Issuer X proposes to develop 26 oil and gas wells. Initially planning to raise capital in one Rule 506(b) offering, Issuer X is advised that the offering will be limited to 35 non-accredited investors. In response, Issuer X creates 26 limited liability companies and conducts 26 ostensibly separate offerings, accepting a total of 127 non-accredited investors. Is Issuer X (1) smart, or (2) entitled to one phone call?

The same concepts will apply to offerings by affiliates under Regulation A+. Factors include:

- Whether the offerings are part of a single plan of financing
- Whether they involve the same class of securities
- Whether they take place at or about the same time
- Whether the same type of consideration (i.e., cash) is being received
- Whether they are for the same general purpose

Raising Money After Regulation A+

You're likely to have lots of names on your cap table after raising money in a Regulation A+ offering. As we've discovered in Title II Crowdfunding, however, having lots of names on your cap table is not a barrier to raising money in the future, at least if the Regulation A+ offering is structured in the right way. After a Regulation A+ round an issuer can raise money in any way it likes – a private investment, a Title II round, or another Regulation A+ offering. A Regulation A+ round of financing can also be a stepping stone to a full-blown IPO.

Sales by Title II Portals

If you're in the business of listing and selling securities under Title II, you can be in the business of listing and selling securities under Regulation A+ as well. Securities may be sold under Regulation A+ using "general solicitation and advertising," just like securities under Title II. You will, however, need to build into your platform a whole new set of functionality.

CAUTION: The JOBS Act exemption from broker-dealer registration *does not apply to Regulation A+ offerings.* So if you're relying on that exemption – which you probably shouldn't be anyway – you might need to register as, or affiliate with, a broker-dealer.

Resales of Securities

Securities purchased in a Title II offering are subject to Rule 144, which limits resales for specified periods of time. In contrast, securities purchased in a Regulation A+ offering may be sold the very next day, at least as far as the securities laws are concerned. The issuer, of course, is likely to impose contractual restrictions on transfers.

None of this will matter much until we have a robust secondary market for Crowdfunded securities. That was the gist of Commissioner Gallagher's comments, when he advocated for the creation of so-called "venture exchanges" in a statement issued with the adoption of the final rules. Probably wishful thinking before the next Presidential election, but stranger things have happened.

Number of Investors

A company with more than 2,000 shareholders, or more than 500 non-accredited shareholders, is generally required to register with the SEC. A shareholder who acquired his stock in a Regulation A+ offering will not be counted toward those limits under certain limited circumstances.

Sales By Owners

Unlike Title II Crowdfunding, which allows sales only by issuers, Regulation A+ allows the existing stockholders of an issuer to sell shares as well, in effect "cashing out." However, sales by existing owners are limited.

At the time of the Regulation A+ offering and for 12 months afterward, sales by existing stockholders cannot exceed 30% of the aggregate offering price. So, for example, if the aggregate price of all securities offered, by the issuer and the existing stockholders, is $15 million, then during the first year existing stockholders may sell no more than $4.5 million.

After that 12 month period, it depends on whether the selling stockholder is an affiliate of the issuer:

- Affiliates may sell no more than $6 million of stock if the offering was under Tier 1, or $15 million if the offering was under Tier 2.
- Non-affiliates may sell as much stock as they like, subject only to the maximum offering limits, i.e., $20 million for Tier 1 and $50 million for Tier 2.

Links

Here are links to:

- The final regulations and the SEC preamble
- Title IV of the JOBS Act
- The statements issued by the SEC Commissioners with the final regulations

Giving Credit Where Credit is Due

My friend and colleague Sam Guzik, Esq. of Guzik & Associates has played an important, not to say critical, role in giving birth to Regulation A+. Sam has prodded and cajoled and recommended and provoked – the word is that he has SEC Chair Mary Jo White on his speed dial while she has him on her Blocked list. The Crowdfunding industry is indebted to Sam for his tireless work.

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