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Regulation A+ IPO or The Mini-IPO; Remarkably Effective and Widely Misunderstood

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Introduction

A recent article in the Wall Street Journal by Ruth Simon revealed that, "Roughly a year after the passage of new rules making it easier for fledgling businesses to tap U.S. capital markets, just a handful of them have succeeded in doing so. A Phoenix-based startup that makes three-wheeled vehicles raised roughly $17 million through one such mini-IPO, in which small companies can raise as much as $50 million by issuing securities. Two other companies together have raised nearly $70 million for real estate investments, while a community bank with operations in three Southern states has issued stock for a merger deal."

It seems that even though smaller companies have been afforded a tremendous financing opportunity by the passage of Regulation A+ few have taken full advantage of the "mini-IPO." According to MS. Simon, small companies still face several obstacles when raising investor capital; a weak market for initial public offerings, insufficient marketing abilities to attract investors, overoptimism when calculating the minimum amount of money needed to complete the offering, and the JOBS Act's limited progress in achieving its objectives.

The most prevalent hurdle is also ironically the simplest to overcome; attorneys and broker-dealers do not fully understand Regulation A+ and are consequently still not comfortable with the new fund-raising option.

Attorney Laura Anthony, founding partner of the corporate law firm Legal & Compliance, LLC, joined Andy Kyzyk, Vice President of Advisor Relations for OTC Markets Group, to host a panel discussion on Regulation A+. The Mini-IPO Investor Webinar was presented by VirtualInvestorConferences.com, created by BetterInvesting (NAIC) and PRNewswire. The purpose of the webinar was to elaborate on how Regulation A+ works and what issuers, investors, attorneys and broker-dealers really need to know.

What is Regulation A/A+?

Good morning. I'm attorney Laura Anthony, founding partner of Legal & Compliance, a corporate and securities law firm with an active Regulation A+ practice. I understand that many of you here today are retail investors and are probably wondering: What is Regulation A or A+?

Regulation A+ is simply a legal process allowing companies to file a registration statement with the SEC that in turn can be used to sell debt or equity securities to the masses to raise capital.

To be clear, it is just a legal process that allows some neat benefits to companies raising capital, such as active advertising and solicitation including through social media. There is no pool of funds to tap into; it is not a line of credit; it is just another process that companies can use to reach out to you, the investing public, and try to convince you to buy stock in, or lend money to, their company.

Like any registered securities, securities sold in a Regulation A+ transaction are not restricted and so they are available to create a secondary market and be traded such as on the OTC Markets or a national exchange.

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History of Regulation A+; Goals and Purpose

I keep saying Regulation A+, which as many of you are aware is a relatively new term. The original Regulation A was adopted in the 1960s as a sort of short-form registration process with the SEC. However, since Regulation A still required a lengthy and expensive state review and qualification process, known as “blue sky registration,” over the years it was used less and less until it was barely used at all. Literally years would go by with only a small handful, if any, Regulation A filings; however, the law remained on the books and the authors and advocates behind the JOBS Act saw potential to use Regulation A to democratize the IPO process by implementing some changes.

Without going down a rabbit hole on “blue sky laws” from a high level, in addition to the federal government, every state has its own set of securities laws and securities regulators. Unless the federal law specifically “pre-empts” or overrules state law, every offer and sale of securities must comply with both the federal and the state law. There are 54 U.S. jurisdictions, including all 50 states and 4 territories, each with separate and different securities laws. Even in states that have identical statutes, the state’s interpretations or focus under the statutes differs greatly. On top of that, each state has a filing fee and a review process that takes time to deal with. It’s difficult, time-consuming and expensive.

Title IV of the JOBS Act that was signed into law on April 5, 2012, set out the framework for the new Regulation A and required the SEC to adopt specific rules to implement the new provisions, which it did. The new rules quickly became known as Regulation A+ and came into effect on June 19, 2015. As I’ll discuss further, Regulation A+ has a path to pre-empt state law, and allows for unlimited marketing – as long as certain disclaimers are used, and of course, subject to antifraud laws – you have to be truthful.

As with all of the provisions in the JOBS Act, Regulation A+ was created to provide a less expensive and easier method for smaller companies to access capital. One of the biggest impediments to reaching potential investors has always been strict prohibitions against marketing offerings – whether the offerings were registered with the SEC or under a private placement. Historically, companies wishing to sell securities could only contact people they know and have a business relationship with – which was a small group for anyone. Even the marketing of non-Regulation-A-registered offerings and IPO’s has been strictly limited. The use of a broker-dealer would be helpful because a company could then access that broker-dealer’s client base and contacts, but broker-dealers are not always interested in helping smaller companies raise money.

The JOBS Act made the most dramatic changes to the landscape for the marketing and selling of both private and public offerings since the enactment of the Securities Act of 1933, one of which is the overhaul of Regulation A, which we are talking about today.

In essence, Regulation A+ has given companies a mechanism and tools to empower them to reach out to the masses in completing an IPO and has concurrently put protections in place to prevent an abuse of the process.

Specifics of Regulation A+ - How does it work?

The new Regulation A+ actually divided Regulation A into two offering paths, referred to as Tier 1 and Tier 2. Tier 1 remains substantially the same as the old pre-JOBS Act Regulation A but with a higher offering limit and allowing more marketing. The old Regulation A was limited to offerings of $5 million or less in any 12-month period. The new Tier 1 has been increased to up to $20 million. Since Tier 1 does not pre-empt state law, it is really only useful for offerings that are limited to one but no more than a small handful of states. Tier 1 does not require the company to include audited financial statements and does not have any ongoing SEC reporting requirements. Tier 1 will likely not be used for a going public transaction.

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I don't have a lot to say about Tier 1, except that as an investor, you need to be cognizant of the terms and foundation of any securities being offered to you. If the offering is Tier 1, you need to be aware that the company has no ongoing disclosure or reporting obligations to provide information to you, and be aware of what your exit strategy is since these offerings are not used to create a secondary trading market.

Tier 2 is where the fun is. Tier 2 allows a company to file a registration statement with the SEC to raise up $50 million in a 12-month period. Tier 2 pre-empts state blue sky law. The registration statement is a little less lengthy than a traditional IPO registration, the SEC review process is a little shorter, and a company can market in a way it cannot with a traditional IPO. The trade-off is that Regulation A+ is limited in dollar amount to $50 million, there are specific company eligibility requirements, and there are investor qualifications and associated per-investor investment limits.

Also, the process is not inexpensive. Attorneys' fees, accounting and audit fees and, of course, marketing expenses all add up. A company needs to be organized and ready before engaging in any offering process, and especially so for a registered offering process. Even though a lot of attorneys, myself included, will provide a flat fee for the process, that flat fee is dependent on certain assumptions, including the level of organization of the company.

Now I'll drill down on some of these points.

Eligibility

First, eligibility – or what companies are eligible to use Regulation A+ to raise capital? Only companies organized and operating in the United States or Canada are eligible to use Regulation A+. U.S. and Canadian companies are not prohibited from having some international subsidiaries or operations, but the company must be based in either the U.S. or Canada.

Also, hedge funds or similar funds that pool money to invest in other companies are not eligible. Likewise, companies with no particular business plan accept to acquire another company – commonly known as SPAC's – cannot use Regulation A+. Companies offering fractional undivided interests in oil, gas or other mineral rights are not eligible. Unfortunately, in what is clearly a legislative miss, companies that are already publicly reporting – that is, are already required to file reports with the SEC – are not eligible. OTC Markets has petitioned the SEC to eliminate these eligibility criteria, and pretty well everyone in the industry supports a change here, but for now it remains.

Finally, a company that is disqualified under "bad actor" rules cannot use Regulation A+. The bad actor rules are there to protect investors and disqualify the company from using Regulation A+ if the company itself, its predecessor or an affiliate such as an officer, director, 20%-or-greater shareholder, promoter, broker or others directly involved in selling the offering have been subject to certain administrative orders, industry bars, injunctions involving certain securities law violations or certain specified criminal convictions all within the last 5 years or 10 years depending on the disqualifying event. Eligible companies can only offer debt or equity securities or securities convertible into debt or equity such as options and warrants.

The Process/Who Can Invest

Next, I'll touch on the process. A company using the Regulation A+ process must file a registration statement with the SEC on a Form 1-A. The offering statement contains information about the company and the offering, including, for example, material risks; plan of distribution; use of proceeds; description of the business operations; discussion of financial condition and results of operations (MD&A); disclosure about directors, executives and key employees; executive compensation; beneficial security ownership information; related party transactions; and two years of financial

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information. For a Tier 2 offering, that financial information must be prepared in accordance with U.S. GAAP and audited by a PCAOB licensed auditor.

The registration statement must include information to confirm that the company is eligible to use Regulation A, including that there are no bad actor issues. The registration statement will also have numerous exhibits, such corporate records and material contracts and agreements.

Of course, the particulars of the offering, such as what is being sold and at what price, need to be included. Key to this information is a reasonable valuation and rational use of proceeds. A company should demonstrate value through its financial statements and disclosures and establish that the intended use of proceeds will result in moving the business plan ahead and hopefully create increased value for the shareholders. Investors want to know that their money is being put to the highest and best use to result in return on investment. Repayment of debt or cashing out of series A investors is generally not a saleable use of proceeds. Looking for $50 million for 30% of a pre-revenue start-up just isn't going to do it! The company has to be prepared to show you, the investor, that it has a plan, management, vision and ability to carry out the business proposition it is selling.

Like all offerings, the registration statement is subject to the federal antifraud provisions. The federal law prevents a person or company from making an untrue statement of a material fact or omitting a material fact in connection with the purchase or sale of a security. The ultimate goal of the registration process is transparency and disclosure, and you, the investor, have the right to receive adequate information to make an informed investment decision.

Once the registration statement is filed with the SEC, a comment and review process will begin. The SEC will issue comments to the company and the company will, in turn, answer those comments and file amendments to the original Form 1-A, making changes required by the SEC comments. After a few rounds, the SEC will have no further comments and the registration statement can be declared "qualified," meaning sales can commence.

Although plenty of marketing can occur before the registration is declared qualified – which I'll talk about next – no actual sales can be made until it is qualified. That is, no money can change hands until the SEC says you're good to go. The time from the filing of the initial registration through qualification by the SEC is generally two to three months.

Once money can change hands, you, the investor, can buy into the offering; however, there are limitations on how much you can buy. If you are an accredited investor – which generally means you have a net worth of greater than $1 million, not including your primary residence, or you make $200,000 a year or more or $300,000 together with your spouse, and have made that much for the last two years and expect to continue to do so – you can invest as much as you want – no limit. However, if you are not accredited, you cannot invest more than 10% of the greater of your annual income or net worth. Like the bad actor rules, this is an investor protection.

Regardless of your investment ability, remember, these are risky investments by nature. Offering materials should be scrutinized. The SEC does not pass on the merits of an offering – only its disclosures. The fact that the registration statement has been qualified by the SEC has no bearing on the risk associated with or quality of the investment. That is for each investor to decide, either alone or with advisors, and requires really reviewing the offering materials and considering the viability of the business proposal. At the end of the day, the success of the business, and therefore the potential return on investment, requires the company to perform – to sell their widgets, keep ahead of the competition, and manage their business and growth successfully.

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Marketing Differences from the Traditional IPO and Testing the Waters

Other than the investment limits, anyone can invest in a Regulation A+ offering, but of course, they have to know about it first – which brings us to marketing. As I've mentioned several times already, one of the most important aspects of Regulation A+ is the ability to market the offering, which is also one of the fundamental differences between a Regulation A+ offering and a traditional IPO – the other fundamental difference being that a traditional IPO still requires state blue sky registration.

Regulation A+ allows for marketing of the offering at any time during the process and by any means. A company can use social media, Internet websites, television and radio, print advertisements, and anything they can think of. Marketing can be oral or in writing, with the only limitations being certain disclaimers and truth. This is serious stuff. Although a company can and should be creative in its presentation of information, there are laws in place with serious ramifications requiring truth in the marketing process. Investors should watch for red flags, such as clearly unprovable statements of grandeur, obvious hype or any statements that sound too good to be true – as they are probably are just that.

I continue to concentrate on Tier 2 offerings, but just a reminder, Tier 1 offerings do not pre-empt state law, so any marketing of a Tier 1 offering needs to consider and comply with state law – which can be tricky where the advertisement can be seen by potential investors in other states, such as on a website. In a Tier 1 offering, website advertisements usually have big, bold disclaimers that investments can only be made by persons in a particular state.

When marketing before the registration statement is filed and during the review process, the company is just gathering indications of interest as no sales can be completed – this process is called "testing the waters." After the registration is qualified, marketing is designed to result in "buy now" solicitations.

When using "test the waters" or pre-qualification marketing, a company must specifically state whether a registration statement has been filed and if one has been filed, provide a link to the filing. Also, the company must specifically state that no money is being solicited and that none will be accepted until after the registration statement is qualified with the SEC. Any investor indications of interest during this time are 100% non-binding – on both parties. That is, the potential investor has no obligation to make an investment when or if the offering is qualified with the SEC, and the company has no obligation to file a registration statement or, if one is already filed, to pursue its qualification. In fact, a company may decide that, based on a poor response to its marketing efforts, it will abandon the offering until some future date or forever.

Once an offering is qualified with the SEC, the marketing is designed to elicit a "buy now" response from investors. The actual purchase of the securities is based on a contract between the company and the investor – usually called a subscription agreement. Subscription agreements are usually written to be irrevocable by the investor – even if the money is in escrow and even if there are still conditions to the ultimate closing of the offering, such as the company reaching a minimum investment amount. Investors need to understand that once they sign the subscription agreement and deposit funds, they are committed. At that point the only way the investment will not proceed is if the company terminates the offering before it closes.

Even though the investor is committed, it is important to read and understand closing conditions and the use of escrow agents. Many offerings are structured with a minimum amount needed to be raised before a closing. In those cases, the funds are usually held in safekeeping by a third-party escrow agent, and the investors should be informed when the minimum is achieved and the investment closed. If the minimum is not achieved and the investment closed in the time specified in the offering documents, all money will be returned and the offering will have failed. This hard fact is a reminder that Regulation A is still just a legal process and ultimately the company has to get out there and sell its securities.

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Since the Regulation A+ process is not inexpensive – again, think attorneys' fees, audit fees, SEC filing fees, and all that marketing – companies should take a hard look at where they are in their business life cycle before deciding to go down this path.

Also, experience has shown that testing the waters doesn't provide a firm indication of whether an offering will be successful or not. The conversion rate from indications of interest to actual sales is very low – some say as low as 5%. On the other side, a very negative response to test the waters efforts should be taken as a strong indication that the offering, at least as planned at that time, is not a great idea.

The Offering Is Closed – What Now?

Once an offering is closed, a company must file a document with the SEC summarizing the offering, including final sales figures. For a Tier 1 offering, this form is called an exit report and is the last report they must file.

For a Tier 2 offering, the company has ongoing SEC reporting obligations – that is, they have an ongoing obligation of transparency and to provide information to its shareholders and the marketplace. A company that completes a Tier 2 offering must file an annual report with the SEC, including annual audited financial statements and a semiannual report with unaudited financial statements. Both of these reports must contain updated information on the company and progress on its business plans. Also, a company must file periodic reports upon the happening of certain material events.

The annual report must be filed within 120 calendar days of fiscal year-end. The semiannual report must be filed within 90 calendar days after the end of the semiannual period. These Regulation A+ reports are less demanding and intensive than standard 10-Q, 10-K and 8-K reports filed by fully reporting public companies – but from a regulatory perspective, no less important. The SEC has recently closed down an offering by a company that failed to file its annual report.

A company that files Regulation A+ reports can qualify to become publicly traded on the OTC Markets.

A company also has the option of filing a short two-page Form called an 8-A, concurrently upon having its registration statement qualified with the SEC. This Form 8-A will take the company from being a Regulation A+ reporting company to a full SEC reporting company. The company would then have to file full reports on Forms 10-Q and 10-K. A company that intends to seek a listing on a national securities exchange as part of its Regulation A+ IPO must use this option and become subject to the full SEC reporting requirements of a public company as a precondition to qualifying to trade on an exchange.

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Securities attorney Laura Anthony is the founding partner of Legal & Compliance, LLC, a national corporate, securities and business transactions law firm. For 23 years Ms. Anthony has focused her law practice on small and mid-cap private and public companies, the OTC market, NASDAQ, NYSE MKT, going public transactions, mergers and acquisitions, private placement and corporate finance transactions, Regulation A/A+, Exchange Act and other regulatory reporting requirements, FINRA and DTC requirements, state and federal securities laws, crowdfunding, general corporate law and complex business transactions.

Ms. Anthony and the Legal & Compliance team have represented issuers, buyers, sellers, underwriters, placement agents, investors, and shareholders in mergers, acquisitions and corporate finance transactions valued in excess of $1 billion. Legal & Compliance has represented in excess of 200 corporate vehicles and private entities in reverse mergers, initial public offerings and direct public offerings.

Attorney Laura Anthony and her experienced legal team provides ongoing corporate counsel to small and midsize private companies, OTC and exchange traded issuers as well as private companies going public on the NASDAQ, NYSE MKT or over-the-counter market, such as the OTCQB and OTCQX. For nearly two decades Legal & Compliance, LLC has served clients providing fast, personalized, cutting-edge legal service. The firm's reputation and relationships provide invaluable resources to clients including introductions to investment bankers, broker-dealers, institutional investors and other strategic alliances.

The firm's focus includes, but is not limited to, compliance with the Securities Act of 1933 offer sale and registration requirements, including private placement transactions under Regulation D and Regulation S and PIPE Transactions as well as registration statements on Forms S-1, S-8 and S-4; compliance with the reporting requirements of the Securities Exchange Act of 1934, including registration on Form 10, reporting on Forms 10-Q, 10-K and 8-K, and 14C Information and 14A Proxy Statements; Regulation A/A+ offerings; all forms of going public transactions; mergers and acquisitions including both reverse mergers and forward mergers; applications to and compliance with the corporate governance requirements of securities exchanges including NASDAQ and NYSE MKT; crowdfunding; corporate; and general contract and business transactions.

Attorney Laura Anthony and her firm represents both target and acquiring companies in reverse mergers and forward mergers, including the preparation of transaction documents such as merger agreements, share exchange agreements, stock purchase agreements, asset purchase agreements and reorganization agreements. Ms. Anthony's legal team prepares the necessary documentation and assists in completing the requirements of federal and state securities laws and SROs such as FINRA and DTC for 15c2-11 applications, corporate name changes, reverse and forward splits and changes of domicile.

Ms. Anthony is an approved PAL and OTC Markets Advisor with OTC Markets Group, the creator and author of SecuritiesLawBlog.com, the security industry's leading source for news and information, included in the ABA Journal's "10th Annual Blawg 100," the producer and host of LawCast.com™, The Securities Law Network, and a contributor to The Huffington Post. Attorney Laura Anthony is recognized by Martindale-Hubbel as one of America's Most Honored Professionals and the recipient of the Martindale-Hubbel Distinguished® Rating.

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Ms. Anthony is a member of various professional organizations including the Crowdfunding Professional Association (CfPA), Palm Beach County Bar Association, the Florida Bar Association, the American Bar Association and the ABA committees on Federal Securities Regulations and Private Equity and Venture Capital. She is a supporter of several community and charities including the Cystic Fibrosis Foundation, Opportunity, Inc., New Hope Charities, the Society of the Four Arts, the Norton Museum of Art, Palm Beach County Zoo Society, and Kravis Center for the Performing Arts. She is also a financial and hands-on supporter of Palm Beach Day Academy, one of Palm Beach's oldest and most respected educational institutions. She currently resides in West Palm Beach with her husband and daughter.

Ms. Anthony is an honors graduate from Florida State University College of Law and has been practicing law since 1993.

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