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Legal Hurdle Cleared For Reg A+ Deals But Market Uncertain

By **Tom Zanki**

Law360, New York (June 15, 2016, 11:27 PM ET) -- With a key legal cloud removed thanks to a recent D.C. Circuit ruling, experts say the big challenge now for Regulation A transactions, which are newly established exempt offerings that some liken to a mini-IPO, will be attracting investors in an uncertain marketplace still adapting to a revamped landscape of private offerings after the Jumpstart Our Business Startups Act.

U.S. Securities and Exchange Commission rules that allow Regulation A issuers to raise up to $50 million without requiring a full-blown registration statement — dubbed Regulation A+ because it enlarged fundraising options from a previous $5 million limit so small it that was seldom used — have yet to make a huge splash one year after taking effect.

But attorneys say the new capital-raising tool, which could conceivably bridge a gap between traditional private placements and genuine public offerings, are inching toward wider acceptance as market players learn the possibilities that Regulation A+ offerings provide.

“We're seeing a slow but sure, steady increase in use and the desire of the market to learn more and find more of these deals to do,” said Robert Kaplan, founding partner at Kaplan Voekler Cunningham & Frank PLC, which focuses on Regulation A deals. “We are on pace, or a little ahead of pace, of where I would have predicted the market would have been after a year.”

The outlook for Regulation A+ deals got a boost Tuesday when the D.C. Circuit upheld SEC rules that enable issuers to bypass state regulators on Tier 2 filings, the larger of two categories of offerings that let issuers raise $50 million in exchange for stricter disclosure requirements.

Several attorneys said the ruling, which rejected protests by Massachusetts and Montana regulators who argued the federal preemption undermined their proper authority to supervise these offerings, was expected on grounds that Congress gave the SEC broad discretion in crafting rules to protect investors. Regardless, it was a welcome decision because it crystallizes the landscape.

Now that Regulation A+ deals can operate with greater legal and regulatory clarity, experts say the biggest obstacle is persuading the marketplace that these transactions fill a key void. Attorneys say more issuers are inquiring about Regulation A+ offerings, though such deals have yet to gain traction with institutional investors or large investment banks.

“The jury is still out as to whether there is going to be a shift in paradigm,” said Albert Lung, counsel at

Morgan Lewis & Bockius LLP.

A big concern with Regulation A+ offerings is the lack of secondary market options that provide liquidity for stockholders who want to sell their shares.

One option Regulation A+ companies have is to apply to list on Nasdaq, although that requires the added expense of becoming a full SEC reporting company. To avoid these costs, issuers can also list over the counter with OTC Market Groups Inc., which is separately lobbying the SEC to allow existing public reporting companies the right to issue Regulation A+ offerings, but over-the-counter stocks can be perceived as riskier stocks that don't meet the standards of major exchanges.

Morgan Lewis gets many inquiries regarding Regulation A+, but focuses on what it sees as top-quality offerings, Lung said. The firm targets Tier 2 deals that typically involve an investment bank and have the potential to trade on a secondary market like the Nasdaq or OTC.

“We’re focusing on this specific process as an alternative to a traditional IPO,” Lung said. “The advantage is it’s a much less expensive process, and it’s much quicker to go through the SEC.”

The Regulation A+ framework was authorized under the JOBS Act of 2012, which expanded the realm of private offerings available to companies that want to raise capital without incurring the heavy cost of filing an initial public offering. The Regulation A+ offering is also touted as a ramp for a potential IPO if a company later decides to go public.

Companies can choose a Tier 1 offering, which is capped at $20 million and requires state approval but fewer disclosure obligations. Under Tier 2, issuers can raise up to $50 million without needing state approval but must provide more comprehensive offering statements and comply with ongoing federal reporting requirements, albeit less so than a full SEC reporting company.

Since the rules went into effect on June 19, 2015, more than 100 companies have filed offering statements, of which the SEC has qualified 49, according to data tracked by Morgan Lewis. An SEC study in February said Regulation A+ applications were about evenly split between Tier 1 and Tier 2 companies.

Experts say companies suited for Regulation A+ can span from prerevenue life science and medical device companies — capital-hungry businesses that often require funding injections to stay alive — to real estate investment trusts and consumer companies with legions of loyal followers. Startup automaker Elio Motors, known for making three-wheeled cars, completed a $17 million Regulation A+ offering earlier this year, and its shares now trade over the counter.

“Elio benefited from a strong set of customers that also wanted to become investors," said Andrew Stephenson, vice president of product management and strategy at CrowdCheck Inc., a diligence and compliance company that advises issuers on Regulation A+ and other private offerings.

Whether more companies will take the plunge will depend on whether existing issuers are able to demonstrate success with their Regulation A+ offerings, experts say. The absence of a track record in the one-year history of the new option doesn’t yet offer much indication.

“If people see it as a viable pathway, you may see increased utilization,” Gibson Dunn partner Glenn Pollner said. “It will be interesting to see how things play out for the early adopters.”

To date, few investment banks have participated in Regulation A+ deals, many of which are self-underwritten. One exception is WR Hambrecht + Co., a smaller investment bank that is working to carve a niche in this space. The firm has advised higher-profile Tier 2 deals like Elio and digital video news agency NewsBeat Social, which plans to list on Nasdaq.

“We haven’t seen much in the way of investment banks underwriting, and that would certainly change the risk factors for investors,” Stephenson said. “If that happens, that could also be a big change in how Reg A is used.”

Another factor the market is still sorting out is where Regulation A+ deals fit with other private offerings made available by the JOBS Act. Those alternatives include equity crowdfunding and new rules that allow companies to market traditional Regulation D private placements online through general solicitation, albeit under certain restrictions.

Covington & Burling LLP partner Keir Gumbs said Tier 2 companies will have to decide whether they want to comply with the reporting regimes required of them, including providing audited financial statements and filing annual and semiannual reports with the SEC after their offering.

“Those are still relatively major hurdles for companies that could alternatively just do a private traditional placement,” Gumbs said. “I personally think that there will be a niche for Reg A offerings, but it will be a niche. I don’t think it’s likely they would supplant private placements.”

D.C. Circuit Judges Douglas H. Ginsburg, David B. Sentelle and Karen L. Henderson sat on the panel.

Massachusetts is represented by Maura Healey, Robert E. Toone and Sookyoung Shin of the Massachusetts Attorney General's Office. Montana is represented by Jesse Laslovich and Nick Mazanec of the Montana Attorney General's Office.

The SEC is represented by Jeffrey A. Berger, Randall Quinn and Benjamin Vetter.

The case is Monica J. Lindeen v. Securities and Exchange Commission, case number 15-1149, in the U.S. Court of Appeals for the D.C. Circuit.

--Editing by Christine Chun and Jill Coffey.
