REGULATION A The New Kid on the Block

By Joseph B. LaRocco

In the last issue of NBIZ we examined "Secrets of the Reverse Merger" and ended that section talking about Regulation A, which is titled, "Conditional Small Issues Exemption". In this article I will examine Regulation A in relation to Regulation D.

Overview

While Regulation A has been around since 1992, it is a relatively unknown and seldom used offering exemption that small companies can use to raise capital by selling their securities. Regulation A allows companies, public or private, that meet certain terms, conditions and disclosure requirements to make a public offer or sale of securities that is exempt under section 3(b) from the registration requirements of the Securities Act of 1933.

Regulation A is not available to publicly reporting companies that are on the over-the-counter Bulletin Board, American Stock Exchange or Nasdaq. The Regulation A exemption is also not available to development stage companies that either have no specific business plan or purpose, or have indicated that their business plan is to merge with an unidentified company or companies.

Along with other requirements, the exemption is available to companies that have been organized under the laws of the United States or Canada, and have a principal place of business in the United States or Canada.

Currently Regulation D is the most widely used exemption for companies to raise capital. It has only been in the last year that Regulation A seems to be getting some notoriety of its own and seeing more frequent use. Whether Regulation A or D is being relied upon for an offering, company counsel needs to review the applicable state securities laws to be sure it is in compliance with blue sky and other regulatory requirements.

Regulation D vs. Regulation A

Regulation D – Rules Governing the Limited Offer and Sale of Securities Without Registration under the Securities Act of 1933.

Private and public companies are permitted to use Regulation D, however, there are several requirements that make the process more difficult to raise capital. First of all Regulation D is commonly referred to as the "Private Placement Exemption" because general solicitation or advertising are not permitted to locate interested investors.

When a company sells securities pursuant to a Regulation D offering the shares are not yet free trading, they must be registered, usually on a Form SB-2 Registration Statement that is filed with the SEC. The SEC has 30 days to review and comment on the filing, and they almost always do have comments. Each time the company responds to those comments, the SEC has another 30 days to review and comment again. It is not uncommon for companies to go through several rounds of comments.

There is no limit on the amount of time in which the company must respond to the SEC's comments and there have been some situations in which the SEC has so many comments that the company gives up or withdraws its registration statement. In that case, the investors must typically wait one year and then can only sell every 90 days, that number of shares equal top one percent of the company's issued and outstanding common stock.

A long delay by the company or several requests for additional information by the SEC could result in the company's financials gong stale, however, and that would require the company to update its financials.

The SB-2 Registration Statement requires two years of audited financials so the audit fees can be a large expense for a small company. Also, the filing must be done through the SEC's EDGAR System (Electronic Data and Gathering and Retrieval) which is another added expense since the filing has to be EDGARIZED.

Most investors in a Regulation D Private Placement are "accredited investors" which basically means they earn at least $200,000 per year, or $300,000 per year combined with their spouse or have $1,000,000 in net worth. Brokerage firms are used most often to help companies raise capital through their client base of accredited investors which is comprised of wealthy individuals and hedge funds.

Although up to 35 unaccredited investors can be included, the disclosure of information required when you accept money from unaccredited investors is much more vigorous. The company, its officers and directors also expose themselves to more risk of a potential lawsuit. Some law firms will not even handle the documentation for a client if they decide to include unaccredited investors.

Regulation A – Conditional Small Issues Exemption From Registration Under the Securities Act of 1933.

Private and public companies are permitted to use Regulation A and overall the process is a little easier and a bit less costly to get through than Regulation D. Regulation A does not have to be a private placement like Regulation D and even allows for the company to make a "solicitation of interest" publicly to see how much interest there is from the general public in purchasing the company's shares. The solicitation of interest must be pre-filed with the SEC, however, and companies should check with the applicable states regarding their requirements if a solicitation of interest is being considered.

The process of raising the capital and then registering the shares is actually done in reverse pursuant to Regulation A. Companies are not allowed to sell securities under the Regulation A exemption until their filing with the SEC on Form 1-A is "qualified," which basically means approved. Once it is qualified the stock that is then sold to investors does not bear a restrictive legend and can be freely traded.

Thus, if the company is already public when the Form 1-A is qualified, investors would be allowed to immediately sell some or all of their stock to try and take some profit from their investment. Therefore, Regulation A would seem to be more appealing to investors since they have more liquidity of their investment, assuming of course the company is already public with a stock symbol and there is liquidity in the market for that stock.

The SEC has only 20 days to review and comment on the Form 1-A filing, and just like a registration statement filing, they almost always have comments. Each time the company responds to those comments, the SEC has another 20 days to review and comment again which can go through several rounds.

The Form 1-A requires two years of financials, but they do not have to be audited financials, so the company can save some money. Also, unlike the registration statement to be filed in a Regulation D transaction, the Form 1-A filing is simply a paper filing.

The company needs to disclose detailed information on Form 1-A such as information about the officers, directors and principal shareholders, disclosure of previous securities sales, description of the company's business, risk factors, corporate structure, use of proceeds and any other material factors that should be disclosed.

Although Regulation A does not allow a company to actually sell shares and raise capital until the Form 1-A is filed and qualified by the SEC, sales can be made to "unaccredited investors" so the pool of potential investors is much larger.

Let's say for instance that your company is in a growth stage and has been growing 30 percent each year for the last three years. If you raise 250,000 you feel pretty strongly that you can grow the business an additional 100 percent in 12 months. You also know that you have many family members, friends and business contacts that would probably invest in your company, but unfortunately hardly any of them are accredited investors.

If you were relying on Regulation D, your pool of available investors would be greatly limited in two ways: (1) you can only approach investors that your already know to meet the requirement of the "private placement" exemption and (2) those investors must meet the "accredited investor" definition. Also, there has been some discussion by the SEC that they are considering increasing the income and net worth requirements for accredited investors which would shrink that pool of investors even more. Regulation A seems to be the easy solution to this particular problem.

Regulation A as a Step to a Public Listing

One particular use being made of Regulation A more and more is to increase a company's shareholder base of shareholders with free trading stock. This is important because when a company uses a market-maker (broker-dealer firm) to file a Form 211 with Nasdaq to obtain a stock symbol, there are two important factors to be considered before Nasdaq even considers the fundamentals of the company. Those factors are (1) at least a shareholder base of 35 and (2) shareholders with free trading stock that is unrestricted.

These factors are important because Nasdaq and the SEC are no longer allowing the formation of public shells with no specific business plan and no operations other than to acquire yet to be identified business. The formation of shells led to much abuse over the years and was rampant with pump and dump schemes.

Future Outlook for Small Public Companies

When the U.S. Securities & Exchange Commission (SEC) adopted Regulation A they clearly had the intent of helping small existing companies raise capital. One of the reasons why it has not seen much use is probably because most investors in the microcap sector, which includes private investors, investment bankers and hedge funds, want liquidity in their investment.

Up till now Regulation A has not been used properly to give them that liquidity, since it is only available to private companies and public companies listed on the PinkSheets. PinkSheets® LLC runs an Electronic Quotation Service for over-the-counter securities markets. For more information go to www.pinksheets.com.

What exactly is PinkSheet company you might ask? Well, it is a publicly traded company with a stock symbol that does not meet the reporting requirements to get listed on a US exchange or on the Nasdaq Stock Market. These companies either choose not to list, or are unable to meet the standards for listing, on Nasdaq or a US stock exchange.

Larger investors that make investments of $100,000 or more usually stay away from PinkSheet listed companies because there is not enough publicly available information about them. A recent development has been taking place over the past few years, however, and the people who run PinkSheets are demanding more disclosure and are trying to clean up the penny stock business in a big way. They even made a recent proposal regarding tightening up some of the SEC regulations regarding investor relations firms that have been touting penny stocks and spamming people with phony stock tips.

I'm sure the SEC is applauding the efforts of the people over at PinkSheets, but at the same time, the SEC has recently acknowledged the decline in competitiveness in U.S. markets. On May 23, 2007, Commissioner Roel C. Campos remarks at the SEC Open Meeting regarding "Proposed Rules Regarding Smaller Companies" included the following, "One of the Commission's missions is to promote capital formation. This is especially important for both smaller public companies and also private companies."

There are a number of other proposals the SEC is considering specifically for assisting small companies in their capital raising efforts. Hopefully, the combination of more disclosure by PinkSheet listed companies and new regulations by the SEC will bring much needed capital to the smaller companies that are the lifeblood of our economy.

Be sure to look at the next issue of NBIZ when I will examine PinkSheets to tell you how they intend to clean up the penny stock market and some things you didn't know and should know about penny stocks. **N**

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