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SEC Fines Serve As Warning Against Cutting Corners In Reg A

By **Tom Zanki**

Law360 (May 26, 2023, 4:40 PM EDT) -- Securities regulators' recent fines against companies for allegedly breaking rules governing Regulation A — a capital-raising avenue that offers relaxed requirements compared to an initial public offering — should be a warning for companies to sharpen their compliance if they want to benefit from the IPO alternative, according to attorneys.

On May 16, the U.S. Securities and Exchange Commission charged 10 companies with alleged infractions regarding Regulation A offerings spanning several years. The fines — which the companies agreed to pay without admitting or denying the SEC's findings — ranged from $5,000 to $90,000 and mostly centered on technical matters.

The bigger picture, according to securities lawyers, is that the SEC is ready to enforce violations involving Regulation A offerings, which are designed to give small companies a capital-raising alternative short of the requirements of a full-blown public offering.

"It is underscoring that Regulation A is not a free-for-all," said Morgan Lewis & Bockius LLP partner Erin Martin, who counsels public companies and is a former lawyer for the SEC's Division of Corporation Finance. "To the extent a company wants to avail itself of the benefits that Regulation A provides, they have to be cognizant of the burdens associated with it and ensure that they remain compliant."

Under the Regulation A exemption — often called Reg A for short — companies can raise up to $75 million from the public annually under its Tier 2 program while disclosing less information compared with a registered offering. For instance, companies can disclose fewer years of audited financial statements under a Tier 2 filing compared with a registered offering, and must file such reports semiannually rather than quarterly.

Most companies that use Regulation A raise far less than the maximum $75 million allowed, as evidenced by the SEC's recent spate of enforcement actions. The 10 companies fined on May 16 mostly raised between $1 million and $10 million, with four that raised less than $1 million. All were over-the-counter companies seeking fresh cash in industries spanning from cannabis to renewable and conventional energy.

The SEC's enforcement actions claim a pattern of similar infractions. Several companies allegedly increased the size of their deals, or changed their offering prices without filing correct documents. Others allegedly sold shares at varying prices in the same offering, similar to an at-the-market offering used by public companies, which is not allowed under Regulation A. Meanwhile, others were charged

with failing to update their financial statements as their offerings dragged on for long periods.

Several attorneys interviewed by Law360 said the SEC's actions show that companies can't cut corners when navigating the nuances of Regulation A rules.

"This is an imperfect system with heavy filing requirements," Olshan Frome Wolosky LLP partner Spencer Feldman said. "Still, changing a fundamental term of an offering touches on the SEC's investor protection mantra."

Regulation A was expanded under the Jumpstart Our Business Startups Act of 2012, part of a broader legislation intended to stimulate capital raising in public and private offerings.

The fundraising limit for Regulation A, which was previously capped at $5 million and seldom used before the JOBS Act, was increased to $50 million and later to $75 million. The SEC also overhauled its rules governing Regulation A following the JOBS Act.

Data shows that Regulation A has been used more often since updated SEC rules governing the new version **went live in 2015,** but the offering still only generates modest activity.

A study released in April by Marquette University finance professor David Krause found that an average of 160 Regulation A offerings have been qualified each year by the SEC since 2015, compared with an average of eight per year before 2015. Yet Regulation A offerings in 2021 raised only $5 billion combined, which was less than 1% of all private equity raised in the U.S. that year, according to Krause's study.

Krause's study said several factors could limit Regulation A's appeal, including the lack of secondary trading options for companies that use this avenue, the risky nature of investing in unprofitable, early-stage companies, and perceived high offering costs.

Regulation A deals also take far longer to complete than a standard IPO, in which offering prices are typically finalized within two weeks after a company completes a marketing roadshow. Offerings under Regulation A, which are often used by younger companies with less cash and investor support, can take months or years.

The SEC's recent wave of enforcements allege that as these Regulation A offerings dragged on, several companies made significant changes to their terms by filing circular supplements with regulators, apparently unaware that such changes need to be filed through new offering statements or post-qualification amendments.

Given the small size of their offerings, Regulation A offerings also attract fewer underwriters, which can result in fewer eyes scrutinizing these deals. Krause's study showed that only 25% of Regulation A offerings since 2015 employed underwriters.

Feldman noted that most Regulation A offerings are structured on a "best efforts" basis — meaning unlike firmly underwritten offerings, there is no guarantee all shares will be sold — and they are often conducted on online portals without a hands-on underwriter or broker-dealer.

Morgan Lewis partner Albert Lung said smaller companies that pursue Regulation A offerings tend to have fewer resources and some may not hire sophisticated legal counsel to navigate these offerings,

which can lead to trouble down the road.

"It's about time that the SEC started cracking down," Lung said. "Because you can't let this go on."

Securities attorney Sara Hanks said it will be worth watching whether the SEC and the Financial Industry Regulatory Authority, which oversees broker-dealers, team up on additional enforcement actions in the future to crack down on further noncompliance.

"I think the [SEC] staff has noticed compliance failures in Reg A offerings across the board," said Hanks, who is also CEO of compliance firm CrowdCheck and a former member of the SEC's Small Business Capital Formation Advisory Committee.

The SEC and FINRA declined to comment.

When the SEC announced its charges, its Chicago office enforcement director Daniel Gregus said companies that "choose to circumvent Regulation A's requirements by engaging in prohibited conduct or making fundamental changes to their offerings without qualification will face action by the SEC." "Qualification" is the process in which the SEC reviews a Regulation A offering and permits companies to raise money based on the terms they disclosed.

Gary Ross, a managing partner of Ross Law Group, sees the recent enforcement actions as a sign that the SEC is seeking to ensure compliance with rules with Regulation A, which he said is a viable capital-raising option for certain companies.

Krause's study showed that while Regulation A hasn't taken off, it has found a niche in specific industries. Banks, real estate and investment institutions make up about 35% of filings.

And while Regulation A requires less disclosure than a fully registered offering, Ross noted that it provides more information to investors than private avenues, such as the popular Regulation D exemption often used by many large venture-backed startups.

"The SEC's position is that more disclosure is better than less," Ross said. "They also want people to be aware that even after [an offer is qualified], there are ongoing disclosure requirements."

--Editing by Alanna Weissman.

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