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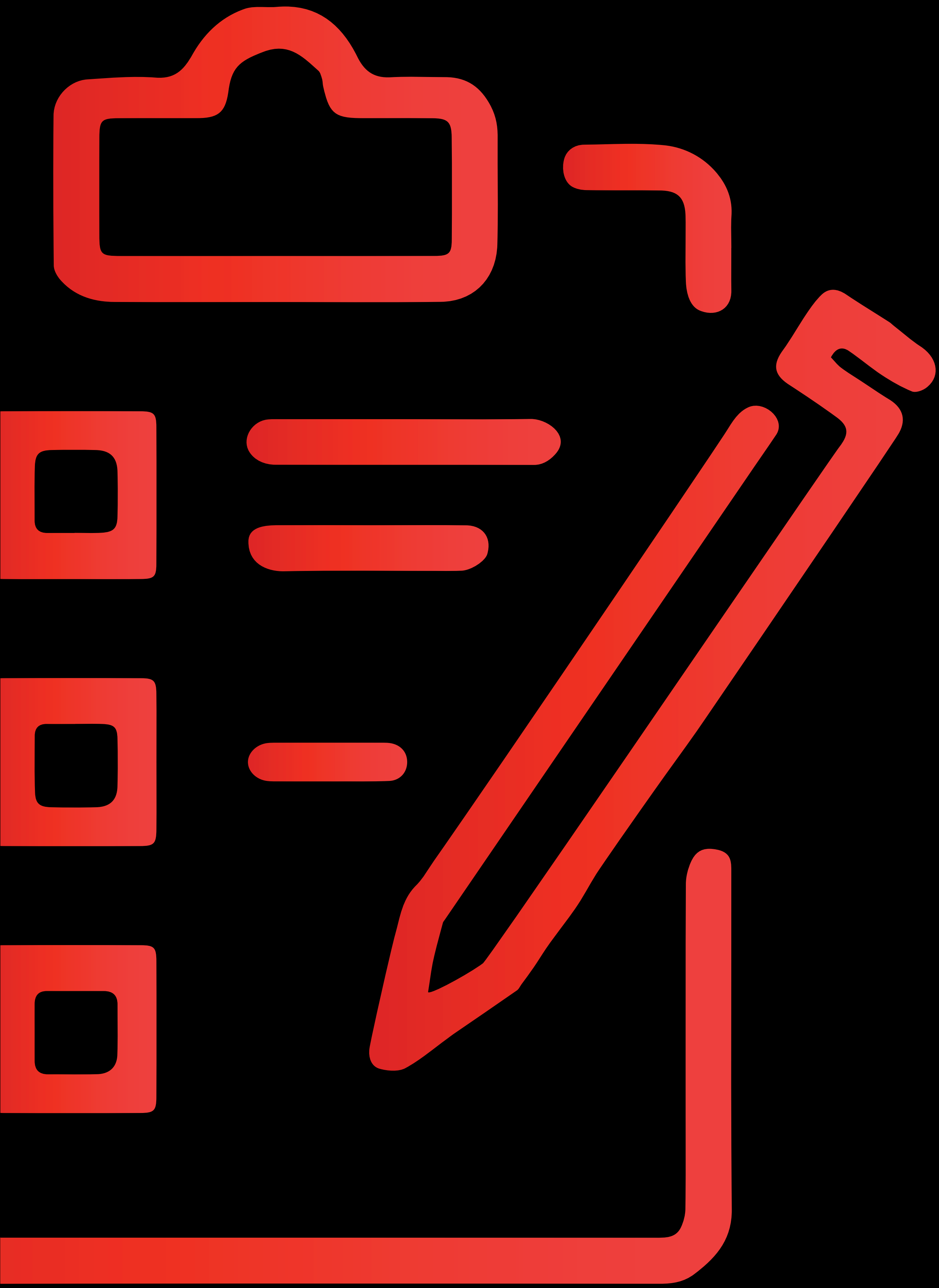

WHAT'S THE DEAL?

TABLE OF CONTENTS

Initial Public Offerings: An Introduction 5
Initial Public Offerings: Pre-Filing Period 13
Initial Public Offerings: Filing and Post-Filing Period 21
Shelf Registration Statements and Shelf Takedowns 31
Private Investment in Public Equity (PIPE) Transactions 41
Registered Direct Offerings 51
At-the-Market Offerings 57
Rule 144A 63
Regulation S 71
Rights Offerings 89
Regulation FD 95
Foreign Private Issuers 107
Special Purpose Acquisition Companies 127
Form 8-K 135
Rule 10b-18 145
Rule 10b5-1 Plans 155
Medium-Term Note Programs 163
Section 3(a)(2) Bank Note Programs 171
Structured Certificates of Deposit 179
Trust Indenture Act 187

ABOUT MAYER BROWN'S CAPITAL MARKETS PRACTICE

We are one of the leading securities and capital markets law firms in the world, advising issuers, underwriters and agents in domestic and international private and public financings.

Our practice is diverse, spanning the financing continuum—from private placements, to IPOs, to Rule 144A and Regulation S offerings, to continuous issuance programs, such as medium-term note and commercial paper programs, to derivatives, structured products and structured finance and securitization transactions. We also represent issuers and SPACs on initial business combinations, as well as advising in connection with SPAC PIPE transactions and related matters.

We advise privately held companies and public companies, as well as placement agents, in connection with private placements of equity, equity-linked and debt securities. We count among our capital markets lawyers innovators in the private placement and PIPE market.

In addition, we regularly counsel companies, placement agents, private investors and strategic investors in connection with mezzanine or late-stage private placements. Given the depth of our experience with private placements and IPOs, we are able to work effectively with our clients on these transactions while remaining focused on their strategic objectives and longer-term financing plans.

While we have exceptional credentials in many areas, we consider one of our greatest strengths to be our global network and our ability to marshal our resources and bring them to bear on complex cross-border transactions, joining together with a shared commitment to practical and timely advice.

Questions? Contact any member of Mayer Brown's Capital Markets Practice with questions on the topics covered in this book.

Here's the Deal:

- An initial public offering ("IPO") refers to the initial offering by a company of a class of its equity securities, usually with a contemporaneous listing of that class of securities on a national securities exchange.
- Although there is no perfect time to effect an IPO, a company should consider the overall market conditions, investor appetite for risk, its anticipated valuation, the needs of existing securityholders for liquidity, its preparedness to address the reporting and other responsibilities associated with being a public company and the specific benefits and drawbacks associated with completing an IPO.
- For discussion purposes, the IPO process can be divided into roughly three periods — the "pre-filing period," the "pre-effective period" and the "post-effective period" — each period is defined by the different tasks that the company will need to complete and the stages of review undertaken by the SEC.
- An IPO requires the involvement of a variety of parties, including that of underwriters, legal counsel to the company and the underwriters, accountants, an investor relations firm, a transfer agent, a financial printer and the equity research analysts associated with the investment banks that are acting as underwriters, each of which play a crucial role in the process of going public.

What's the Deal?

An IPO is the initial public offering by a company of a class of its equity securities, typically its common stock. An IPO is usually an offering that is registered under the Securities Act of 1933, as amended (the "Securities Act"), and the class of securities are often but not always listed on a national securities exchange, such as the New York Stock Exchange ("NYSE"), the NYSE American or one of the Nasdaq Stock Markets ("Nasdaq" together with the NYSE, the "exchanges"). In an IPO, the company may offer newly issued shares of its common stock and/or existing stockholders may offer their shares of common stock for resale (a "secondary" component). After completion of an IPO, a company becomes a "public company," subject to all of the rules and regulations applicable to public companies, including those of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and those of the exchange on which its securities are listed or quoted.

Considerations for a Company Contemplating an IPO

A company that is seeking greater access to capital, increased visibility and liquidity may decide to go "public." Although, there is no right answer or right time for a company to make the decision to go public, there is a market consensus that a "window" exists for certain types of companies to effect an IPO. Whether the window is "open" or "closed" usually depends on the overall economic conditions and investor appetite for risk. In addition to considering the overall receptivity of investor sentiment for an IPO, a company should also consider the advantages and disadvantages of an IPO, including, but not limited to those summarized below.

ADVANTAGES

- An IPO allows a company to raise capital. Unlike a private offering, there are no restrictions imposed on a company with respect to the type or number of offerees or to the number of securities it may sell in an IPO. The net proceeds that are received from the securities sold in an IPO may be used for general corporate purposes, such as working capital, research and development, retiring existing indebtedness and acquiring other companies or businesses.
- Going public creates a market for a company's securities, allowing a company to have greater access to capital in the future. Once a public market for its securities exists, a company may be able to conduct follow-on equity offerings in the future to finance its growth. A company also may be able to use its stock to acquire other companies as part of an acquisition strategy.
- Companies achieve greater visibility after an IPO. That is because the media and research analysts will have greater economic incentive to cover a public company due to the number of investors seeking information about their investment.
- A public company may also use its equity to attract and retain management and key personnel. Once a company has gone public, a company's employees can share in its growth and success through stock options and other equity-based compensation structures that benefit from a more liquid stock with an independently determined market value. Similarly, existing stockholders may want a company to undertake an IPO in order to monetize all or part of their investment in the company.

DISADVANTAGES

The IPO process is expensive. The legal, accounting and printing costs are significant and these costs will have to be paid regardless of whether an IPO is successful.

A company will incur higher ongoing costs as a public company, in order to comply with the requirements of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd Frank"). In addition, obtaining and maintaining directors' and officers' ("D&O") insurance adequate for a public company will be costly.

Once a company is public, certain information must be disclosed to the public, including executive compensation, financial information and material agreements. Therefore, after an IPO, a company may also face increased public scrutiny.

Recent IPO Trends

Before choosing to undertake an IPO, a company will likely want to consider recent trends. During the dotcom boom of the late 1990s, many technology companies had no revenues or profits. Therefore, IPOs became an important capital raising tool that technology companies could implement to raise growth

capital. However, regulatory developments and market dynamics have changed leading to an overall decline in the number of IPOs on a historical basis. This decline can be attributed not only to increased regulations relating to equity research, but also to enhanced corporate governance requirements for public companies, a decline in the liquidity of small and mid-capital stocks and other significant market structure and regulatory developments.

After the dotcom bust, there was a slight increase in the number of IPOs, but that number quickly declined again after the economic downturn of the 2000s. During the same period, funding alternatives to public capital proliferated, as a number of developments affecting the private capital markets emerged. Additionally, broad pools of capital were created as new or additional investors entered the private capital markets, such as hedge funds, private equity funds, family offices, sovereign wealth funds and crossover funds. Even though significant changes to the IPO process have been implemented, such as those associated with the Jumpstart Our Business Startups (JOBS) Act, there had been no significant sustained overall increase in the number of IPOs compared to the 1990 levels. However, the last two years have led to record-breaking amounts of capital being raised through IPOs.

The IPO market remained relatively stagnant until 2020. In 2020, there were 224 IPOs, which raised an aggregate $86.2 billion in proceeds. Despite the rippling effects of the COVID-19 pandemic, in 2021, an astounding 416 companies raised $155.8 billion of capital through IPOs. By comparison in 2019, there were 160 IPOs, which raised a total of $45.8 billion in offering proceeds. The median market capitalization for an IPO issuer was $928.1 million, with a median of $164.7 million per deal raised, in 2021. Life sciences and healthcare companies dominated the IPO market by number of deals in 2021 and life sciences, technology and financial services companies made up 69.8% of IPOs by number of deals.

The IPO market subsequently took a downturn, but has started to show signs of recovery. In 2022, IPOs raised a total of $8.6 billion in the United States,. In 2023 and 2024, the market saw 127 IPOs (raising $22.2 billion) and 176 IPOs (raising $33.0 billion), respectively. Life sciences and healthcare companies accounted for 43% of all IPOs in 2024, while technology companies accounted for 18% and industrials companies made up 11%.

Another recent trend in IPOs was the surge in 2020 and 2021 of the special purpose acquisition company ("SPAC") IPO. A SPAC is a newly formed company that has no assets or operations and intends to effect an initial business combination with an operating company using the IPO proceeds. For a private target company, combining with and into a SPAC has become a popular alternative to a traditional IPO. This trend can be attributed to increased blue-chip investors sponsoring SPACs and better sponsor-investor alignment structures. In 2020, U.S.-listed SPAC IPOs accounted for more than half of overall U.S.-listed IPOs. This trend continued into 2021, when there were a total of 613 SPAC IPOs and $162 billion of capital raised. SPAC IPO activity also fell after 2021. There were 86 SPAC IPOs in 2022, 31 SPAC IPOs in 2023, and 57 SPAC IPOs in 2024.

Types of Companies that Go Public

Generally speaking, and but for life sciences companies, revenue-generating companies or companies with a shorter path to profitability are more likely to have successful IPOs, compared to companies that are in a development stage or are pre-revenue. There are a variety of companies, which may seek to go public in order to pursue their strategic plans, including:

- *Research and development ("R&D")-based companies*, including pharmaceutical and technology companies, with strong valuations but little current revenue. These companies may decide to undertake IPOs to fund long-term, costly R&D. However, later-stage R&D companies and companies with near-term milestones may also decide to access the public markets through an IPO.
- *Real estate investment trusts* ("*REITs*"), including mortgage REITs, are formed to take advantage of opportunities to purchase distressed or undervalued mortgage-related securities, and equity REITs generally are formed to acquire specific kinds of real estate.
- *SPACs*, a more recent type of blind pool offering, are shell or blank-check companies that have no operations but go public in order to identify and combine with an operating company, using the proceeds of the IPO, and subject to receipt of shareholder approval.
- *Business development companies* ("*BDCs*"), are entities that go public to raise capital and lend to smaller and medium-sized businesses.

The Effects of the JOBS Act on the IPO Process

After the accelerated passages of the Sarbanes-Oxley and Dodd-Frank Acts, business leaders and commentators observed that the regulatory requirements to be met in order to finance companies in the United States became overly burdensome and have discouraged entrepreneurship. In April 2012, the JOBS Act was enacted. The JOBS Act adopted the following provisions that affect capital formation:

- An "IPO on-ramp" for a new category of issuer, EGCs, that offers a number of benefits, including confidential SEC Staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on "test-the-waters" communications with qualified institutional buyers and institutional accredited investors before and after filing a registration statement, and fewer restrictions on research around the time of an offering.
- An amendment to the Securities Act (informally referred to as "Regulation A+") permitting companies to conduct offerings to raise up to $50 million (now $75 million) in any 12-month period through a "mini-registration" process similar to that provided for under Regulation A.
- Higher securityholder triggering thresholds for reporting obligations under the Exchange Act.
- Removal of the prohibition against general solicitation and general advertising in certain private placements.
- A new exemption under the Securities Act for crowdfunding offerings.

The JOBS Act offers an issuer new possibilities for structuring its capital raise.

REQUIREMENTS FOR A COMPANY TO MAINTAIN EGC STATUS

The JOBS Act established a new category of company, emerging growth companies (EGCs). EGCs are issuers (including a foreign private issuer) with total annual gross revenues of less than $1.235 billion (subject to inflationary adjustment by the Securities and Exchange Commission (SEC) every five years) during its most recently completed fiscal year. If a company loses its status as an emerging growth company, the status cannot be reestablished. Status as an EGC is maintained until the earliest of:

- The last day of the fiscal year in which the issuer's total annual gross revenues are $1.235 billion or more;
- The last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (for a debt-only issuer that never sells common equity pursuant to a Securities Act registration statement, this five-year period will not run);
- Any date on which the issuer has, during the prior three-year period, issued more than $1 billion in non-convertible debt; or
- The date on which the issuer becomes a "Large Accelerated Filer," as defined under the SEC's rules.
- With regard to the $1 billion debt issuance test, the SEC Staff has clarified that such three-year period covers any rolling three-year period and is not limited to completed calendar or fiscal years.

An Overview of the IPO Process

As noted above, the public offering process may be divided into three periods:

- *Pre-filing Period*. The pre-filing period is the period from the determination to proceed with a public offering to the filing of a registration statement with the SEC. This is also generally called the "quiet period," and a company is usually subject to limitations on its public communications. For more information, please refer to "What's the Deal? Initial Public Offerings: Pre-Filing Period."
- *Pre-effective Period*. The waiting or pre-effective period is the period from the date of the filing of the registration statement to its "effective date." During this period, a company may make oral offers and certain written offers, but may not enter binding agreements to sell the offered security. For more information, please refer to "What's the Deal? Initial Public Offerings: Filing and Post-Filing Period."
- *Pricing and post-effective*. The post-effective period is the period from the date the registration statement has been "declared effective" by the SEC to the completion of the offering. For more information, please refer to "What's the Deal? Initial Public Offerings: Filing and Post-Filing Period."

The Primary Parties Involved in an IPO and Their Roles

Going public requires putting together a team of external advisors. An IPO team will include a lead underwriter (possibly co-managing underwriters), an independent audit firm with significant public company experience, external legal counsel, a transfer agent and a financial printer. Before completing an IPO, a company is advised to hire an investor relations firm. A company will also need to have an internal IPO team in place, which will include the company's president, CEO, CFO, general counsel, controller and an investor relations or public relations manager. The role of each of parties involved in the IPO team are further described below.

UNDERWRITER AND CO-MANAGERS

For an IPO, a company will first identify one or more lead underwriters that will be responsible for the offering process. A company chooses an underwriter based on, among other factors, its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall reputation. Before choosing an underwriter for the offering, a company will need to keep in mind that the underwriter will have at least two conflicting responsibilities—to sell the IPO shares on behalf of the company and to recommend to potential investors that the purchase of the IPO shares is a suitable and worthy investment. Further, the company should also consider the following questions:

- Does the investment bank have strong research in its industry?
- Is its distribution network mainly institutional or retail?
- Is its strength domestic or does it have foreign distribution capacity?

The underwriter's primary roles will include—marketing the IPO shares, setting the price at which the shares will be offered to the public (after consulting with the company) and, in a "firm commitment" underwriting, purchasing the shares from the company and re-selling them to investors. Following the offering, the underwriter generally will make a market in the stock and facilitate transactions in the company's securities.

Depending on the size of the offering, a company may want to include a number of co-managers in order to balance the lead underwriters' respective strengths and weaknesses. Co-managers are underwriters who agree to purchase a substantial portion of a company's shares and who are involved in drafting the prospectus and marketing the offering. Companies typically choose co-managers that have distribution capabilities or analyst coverage that is complementary to those of the managing underwriter.

IN-HOUSE AND OUTSIDE LEGAL COUNSEL

A company's in-house and outside legal counsel play important roles in completing the IPO. A company's counsel will:

- Prepare the registration statement, prospectus and stock exchange application;
- Communicate with the SEC and the stock exchanges on a company's behalf, responding to any comments they may have;
- Negotiate an underwriting agreement with the underwriters and their counsel; and
- Prepare various other documents, including stock option plans, a company's post-IPO certificate of incorporation and bylaws, committee charters, board minutes relating to the IPO and any required consents, waivers and legal opinions.

Underwriters' counsel will undertake legal due diligence during the offering process and will review the registration statement and prospectus with the company, its counsel and the underwriters. Underwriters' counsel will also:

- Negotiate the underwriting agreement with a company and its counsel;
- Discuss the "comfort letter" with a company's accountants; and

- Submit the underwriting agreement, registration statement and other offering documents for review to the Financial Industry Regulatory Authority.

Eventually company's counsel and underwriters' counsel will then coordinate the closing of the transaction.

AUDITORS AND ACCOUNTANTS

Accountants prepare and audit the financial statements of a company or other entities or properties that must be included in an IPO registration statement. Other services provided by the accountants during the offering process include assisting a company in preparing the other financial portions of the prospectus, such as the summary financial information, selected financial information, capitalization and dilution tables, and any required pro forma financial statements. Additionally, the auditor will work with the company to identify any problems associated with providing the required financial statements in order to seek necessary accommodation from the SEC. The accountants will ultimately provide a "comfort letter" to the underwriters.

OTHER PROFESSIONALS

- *Transfer Agent.* A company's transfer agent coordinates the issuance and tracking of the company's stock certificates, maintaining a list of the individuals and entities to whom the shares are issued.
- *Financial Printer.* A company's financial printer will print and distribute drafts the prospectus to the working group as well as provide copies of the prospectus to the underwriters for distribution to investors. The printer will also file (or confidentially submit) the registration statement and prospectus with the SEC through its Electronic Data Gathering, Analysis and Retrieval (EDGAR) system.
- *Research Analysts.* To increase the company's visibility, a research analyst will cover the company once it becomes public. Depending on the size and type of business of the company, there may be anywhere from two to ten analysts covering the company's stock. Smaller companies, however, may not have any analyst coverage. Research analysts will regularly publish recommendations with respect to the company based on their analyses of the company's financial condition and results of operations. Analyst coverage and publicity may result in introducing the company to potential customers and business partners, as well as reinforcing the company's advertising and product-branding initiatives.
- *Investor Relations Firm*. A company may hire an investor relations firm for the IPO. The firm will help to ensure that the company's communications with the general public, as well as its target market during the offering period, are consistent with the SEC's rules, while continuing to generate interest in the company and its business.

Listing on an Exchange

Listing stock on an exchange is one of the most important steps a company can take to achieving liquidity as part of an IPO. Certain kinds of investors may only invest in exchange-listed issuers. Liquidity and an active market should help establish a widely recognized value for the company's stock, which will help the company use its stock instead of cash for acquisitions and other significant transactions. Listing on an exchange cannot guarantee liquidity or investor interest and there are many companies that have liquid markets even though they are traded in the over-the-counter markets. Exchange listing requirements may be generally described as "quantitative requirements" and "qualitative requirements." Quantitative requirements are financial criteria for listing and include a minimum number of shareholders of the company, a minimum market capitalization, a minimum share price and financial tests. Qualitative requirements are standards relating to the company's business and corporate governance, including the nature of the company's business, the market for its products, its regulatory history, as well as the election and composition of the board of directors and audit committee, issuance of earning statements and the company's shareholder approval requirements.

To list its securities on an exchange, a company must meet the quantitative and qualitative requirements and submit an application to the exchange. In order for shares to be listed on the exchange, in addition to filing a registration statement for the IPO itself under the Securities Act, the issuer must also file a registration statement under the Exchange Act that acts as the continuing registration statement for the company after the IPO is completed. The exchange will review the application and supporting documentation, and, once the listing is approved, the shares will be admitted for trading after the Exchange Act and, if applicable, Securities Act registration statements have been declared effective by the SEC, and the shares have been offered and sold if there is a concurrent IPO. As listing is often critical to the success of an IPO, it is best practice to get such approval before the preliminary prospectus is printed.

Checklist of Key Questions

- ✓ Do the benefits of an IPO outweigh the risks of going public for the company?
- ✓ Has the company considered the current market and recent trends before considering an IPO?
- ✓ Does the company fall into one of the categories of companies that are typically successful in IPOs?
- ✓ Is the company an EGC?
- ✓ Has the company considered the exchange on which it will list its shares in connection with the IPO?

Initial Public Offerings: Pre-Filing Period

Here's the Deal:

- The pre-filing period is an important part of an initial public offering ("IPO"), requiring a number of management, organizational considerations and structural changes before a company can effectuate an IPO.
- Before a company can complete an IPO, the underwriters will want to complete their due diligence process and ensure that any necessary third-party consents have been obtained.
- A company should consider the variety of underwriting arrangements, including "firm commitment" or "best efforts" underwriting arrangements, before an underwriting agreement is finalized.
- Throughout the pre-filing period, the company and its underwriters will want to be cognizant of the limitations on public communications in order to avoid any "gun-jumping" violations.

What's the Deal?

The pre-filing period in an IPO begins once the company and its underwriters have agreed to proceed with an IPO and continues up through the public filing of the registration statement with the Securities and Exchange Commission (SEC).

Corporate "Housekeeping" in Preparation for an IPO

Most companies consider making legal and operational changes before undertaking an IPO. Some of these preparations and considerations often include:

- Meeting federal securities law requirements (including those arising as a result of the Sarbanes-Oxley Act), as well as applicable exchange requirements once the IPO registration statement is filed with, or declared effective by, the SEC, or committing to satisfy these within the applicable compliance periods;
- Adopting anti-takeover defenses, such as a staggered board of directors and blank check preferred stock;
- Analyzing its capitalization to determine whether it will be appropriate after the IPO; and
- Reviewing executive compensation arrangements and benefit plans.

A company will also want to address other corporate governance matters, including:

- Board structure and directors;
- Management committees and member criteria;
- Senior management;
- Identifying, disclosing and/or terminating related party transactions; and
- Directors' and officers' liability insurance.

REVIEWING MANAGEMENT STRUCTURE

A public company must comply with corporate governance requirements imposed by federal securities laws and regulations and the rules and regulations of the applicable stock exchange, including with respect to the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under certain limited circumstances, a majority of the directors be "independent," as defined by both federal securities laws and exchange regulations. In addition, boards of directors should include individuals with appropriate financial expertise and industry experience, as well as an understanding of risk management issues and public company experience. A company will want to begin its search for suitable directors early in the IPO process even if it will not appoint the directors until the IPO is consummated. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors and also designate a committee of the board to undertake the director search.

BOARD COMMITTEES

In addition to assembling its new board of directors, a company will also have to consider the board committees. The passage of the Sarbanes-Oxley Act in 2002 significantly enhanced the independence and expertise requirements for audit committees. The exchanges all require listed companies to have an audit committee, consisting only of at least three independent directors who meet certain standards. At least one of the audit committee members must be a "financial expert."

Separately, the Nasdaq Stock Markets require, subject to certain phase-in rules, a compensation committee comprised of independent directors, but not a nominating committee; while the New York Stock Exchange requires a compensation committee and a nominating/corporate governance committee consisting only of independent directors. The functions of a nominating committee can be performed either by a committee consisting solely of independent directors or by a majority of the company's independent directors operating in executive session. Pursuant to the Dodd-Frank Act and the SEC's implementing rules, exchanges must require that listed companies' compensation committees, among other things, be comprised entirely of independent directors.

Under the rules of the exchanges, the audit, compensation and nominating/corporate governance committees must maintain their own charter, which describes the specific responsibilities of the committee, including the committee's purpose, member qualifications, appointment and removal, board reporting and performance evaluations. If any of the responsibilities of these committees are delegated to another committee, the other committee must be comprised entirely of independent directors and must have its own charter.

Initial Stages of the IPO Pre-Filing Process

ORGANIZATIONAL MEETING

The IPO process usually begins with an organizational meeting attended by representatives of the company, its accountants and counsel, the underwriters and their counsel. The meeting generally includes discussion of the timeline for the offering, the general terms of the offering and the responsibilities of the various parties. The timing of the audited financial statements to be included in the prospectus and any accounting matters or policies that may be of concern should also be discussed. The participants will also discuss reasons for potential timing delays, which may include significant acquisitions or the need to retain additional executive officers.

The organizational meeting may also include presentations by the company's management, some initial due diligence questions by the underwriters and their counsel and a general discussion of the scope and level of comfort that the accountants will be asked to provide with respect to the financial information included in the prospectus.

THE "DUE DILIGENCE" PROCESS

The "due diligence" process is a crucial component of the IPO process as it is an element of the underwriters' diligence defense under the Securities Act of 1933, as amended (the "Securities Act"). More specifically, due diligence is the practice of reviewing information about an issuer in an effort to mitigate liability and reputational risk. After the organizational meeting and during the quiet period, the underwriters and their counsel will spend a substantial amount of time performing business, financial and legal due diligence in connection with the IPO. The process usually starts with a "due diligence request" prepared by the underwriters and their counsel.

Additionally, the company's key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities and financial matters. The underwriters will use these presentations as an opportunity to ask questions. The presentations will also aid the company and the underwriters in drafting the prospectus.

Typical areas of focus for a diligence review include:

- **Business**, including management presentations and discussions, customer and supplier calls or meetings, calls with the company's lenders, trips to company facilities, an in-depth review of the company's financial position and historical results, a review of the company's projections and discussions with the company's accountants;
- **Accounting**, including audits, changes in accounting policies and tax issues, cheap stock issues, capital structure and comfort letters and the level of comfort to be provided;
- **Legal**, including outstanding and even closed claims and litigation, loan agreement restrictions, third-party consents, FINRA issues, the company's intellectual property portfolio, labor issues, environmental, regulatory or other issues and the scope of requested legal opinions; and
- **Management and corporate governance issues**, including composition of the board, director independence, background reports conducted by the underwriters of the board members and

management team, senior management team changes, related party transactions and board actions relating to the IPO.

THIRD-PARTY CONSENTS

Prior to an IPO, a company may have entered into agreements that impose restrictions on its ability to complete the IPO, including:

- Shareholder agreements that may require consents in connection with share issuances or that require the company to register a shareholders' shares as part of the IPO;
- Loan or credit agreements that restrict share issuances or the use of proceeds from the offering; or
- Operating agreements with significant business partners that contain broad "change of control" provisions that may be triggered by the IPO.

The company, with the help of its counsel, should review all of its agreements to identify these provisions and negotiate the necessary consents or waivers with the other parties involved so that they do not jeopardize the timing of the IPO. Companies will want to avoid any last-minute holdup by a shareholder, creditor or supplier or customer that could delay the offering or require the issuer to pay a consent fee or make other concessions.

Underwriting Process

DIFFERENT ARRANGEMENTS WITH UNDERWRITERS

In a typical IPO, the underwriters will have a "firm commitment" to buy the shares being offered by the company (and any selling stockholders) once the conditions specified in the underwriting agreement are satisfied. However, other underwriting arrangements exist, including a "best efforts" underwriting arrangement, in which the underwriters agree to use their best efforts to sell the stock as the company's agents. If purchasers are not found, the stock will not be sold. A best efforts underwriting may provide that no shares will be sold unless purchasers can be found for all of the offered shares, but other arrangements provide that shares may be sold as long as a specified minimum is reached (sometimes known as a "min-max best efforts offering"). The nature of the underwriters' commitment will also affect the ability of the underwriters to engage in certain stabilizing transactions to support the stock price following the IPO.

Typically, the underwriters will be paid a fixed percentage of the total dollar amount of securities sold, usually about 7%. The percentage varies depending on a number of factors, such as the size of the company, its profitability, its industry, etc., but cannot exceed 10%.

UNDERWRITING AGREEMENTS

An underwriting agreement is the agreement pursuant to which a company agrees to sell, and the underwriters agree to buy, shares and then sell them to the public. Until this agreement is signed, the underwriters do not have an enforceable obligation to acquire the offered shares (in a firm commitment offering) or to use their best efforts to place the shares (in a best efforts offering). The underwriting agreement is executed after the offering price is agreed upon, which is typically shortly after the Securities Act registration statement is declared effective by the SEC.

The most important provisions of an underwriting agreement are:

- **Description of the nature of the underwriters' obligation.** The opening paragraphs describe the offering, whether the underwriters have a firm commitment or best efforts obligation and the underwriters' compensation.
- **Representations and warranties.** The company will make statements about its business, finances and assets, the offered stock and the accuracy of the registration statement.
- **Conditions to closing.** Conditions usually include the continued effectiveness of the registration statement and the absence of material adverse changes in the company's business, the results of operations and prospects.
- **Required deliverables.** As a condition of closing, the company will provide opinions of counsel and other experts, certificates confirming the accuracy of the representations and warranties, the initial accountants' comfort letter delivered at the time of pricing the offering and the bring-down letter delivered at closing and other closing documents.
- **Division of expenses.** The underwriting agreement will specify which expenses of the offering are paid by the company.
- **Lock-up agreements.** The underwriting agreement will prohibit the company as well as directors and executive officers from selling equity, except for certain limited purposes, during a period of up to 180 days (subject to negotiation) following the IPO without the managing underwriter's consent. This "lock-up" will also often extend to all, or certainly the largest shareholders, of the issuer. The exceptions from the lock-up provisions can be highly negotiated.
- **Indemnification.** The indemnification section is probably the most important part of the underwriting agreement. In the indemnification section, the company (and sometimes the primary shareholder) agrees to indemnify and be responsible for the underwriters' damages and expenses in the event of any litigation or other proceedings regarding the accuracy of the registration statement and prospectus. The indemnification section will also provide that the underwriters will be liable to the company for misstatements in the prospectus attributable to the underwriters, which information is typically limited to the underwriters' names and the stabilization and similar disclosures. Each underwriter has its own form of indemnification provision and in light of the importance of this section, underwriters are usually reluctant to make changes. It should be noted that the SEC has a long-standing position that indemnification for Securities Act liabilities is unenforceable and against public policy.

FINRA REQUIREMENTS

FINRA is the largest non-governmental self-regulatory organization for all securities firms doing business in the United States. FINRA determines whether the terms of the "underwriting compensation" and arrangements relating to "public offerings" are "unfair and unreasonable." Underwriters' counsel will submit the underwriting agreement, the registration statement and other offering documents for review to FINRA. FINRA reviews the terms of the offering and the underwriting arrangements to determine whether they are "fair and reasonable." FINRA will focus on the compensation to be paid to the underwriters, which could also include certain items of value received in the six months before the IPO. An IPO cannot proceed until the underwriting arrangement terms have been approved by FINRA.

Pre-IPO Disclosures

LIMITATIONS ON CORPORATE PUBLIC STATEMENTS

During the pre-filing period, a company will typically be subject to limitations on its public communications. More specifically, those communications by an issuer more than 30 days prior to the filing of a registration statement are permitted as long as they do not reference the securities offering. However, those statements made within 30 days of the filing of a registration statement, which may be considered an attempt to pre-sell the public offering, will be considered an illegal prospectus and, thereby, potentially be viewed as a "gun-jumping" violation. This could then also result in the SEC delaying the public offering or requiring prospectus disclosure of these potential securities law violations.

Section 5(c) of the Securities Act prohibits offers of a security before a registration statement is filed. Section 5(b)(1) prohibits written offers other than by means of a prospectus that meets the requirements of Section 10 of the Securities Act, such as a preliminary prospectus. These limitations are designed to prohibit inappropriate marketing, conditioning or "hyping" of the security before investors have access to publicly-available information about the company so they can make informed investment decisions. Generally, a company contemplating an IPO does not have much publicly-available corporate information and none of that information has been subject to regulatory review. Until 2005, the Section 5 bans were quite prohibitive, created significant uncertainty about the effects of ordinary business communications and did not address the explosion of new communication technologies since the 1930s. In 2005, in order to modernize the offering process, the SEC adopted the "Securities Offering Reform," which added a number of communications safe harbors to the Securities Act.

QUIET PERIOD

The pre-filing period begins when a company and the underwriters agree to proceed with a public offering. From the first all-hands organizational meeting and going forward, all statements concerning the company should be reviewed by the company's counsel to ensure compliance with applicable rules.

Communications by an issuer more than 30 days prior to filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing a registration statement that could be considered an attempt to pre-sell the public offering may be considered an illegal prospectus, as discussed above. Press interviews, participation in investment banker-sponsored conferences and new advertising campaigns are generally discouraged during this period. In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with, or confidential submission to, the SEC.

GUN-JUMPING

"Gun-jumping" refers to written or oral offers made before the filing of the registration statement and written offers made after the filing of the registration statement, other than by means of a Section 10 prospectus, a free writing prospectus or a communication falling within a safe harbor from the gun-jumping provisions. There are several safe harbors from the gun-jumping provisions applicable to IPOs, including:

- **Rule 134 – Communications Not Deemed a Prospectus.** Rule 134 provides a safe harbor for certain limited information about an offering, such as the name and address of the issuer, the title and amount of the securities being offered, a brief indication of the issuer's business and the names of the underwriters.
- **Rule 135 – Notice of Proposed Registered Offerings.** Rule 135 provides a safe harbor for even more limited notices of proposed offerings that do not include the names of the underwriters.
- **Rule 163A – Exemption from Section 5(c) of the Securities Act for Certain Communications Made by or on Behalf of Issuers More than 30 Days Before a Registration Statement is Filed.** Rule 163A provides a safe harbor for all issuers, provided that the communication is made more than 30 days before the filing of a registration statement and does not reference the securities offering that is or will be the subject of a registration statement.
- **Rule 169 – Exemption from Sections 2(a)(10) and 5(c) of the Securities Act for Certain Communications of Regularly Released Factual Business Information.** Rule 169 provides a safe harbor for communications by all issuers containing regularly released factual information.

Checklist of Key Questions

- ✓ Has the company had an opportunity to undertake a review of its corporate structure, its benefits plans, its executive compensation arrangements, its material agreements and other matters prior to commencing the diligence process?
- ✓ Has the company considered necessary changes to its capital structure prior to engaging with the underwriters? Has the company contemplated changes that it will implement in its bylaws and amended and restated certificate of incorporation upon consummation of the IPO?
- ✓ Has the company assessed whether it will need to bolster its senior management team or its board of directors prior to undertaking its IPO?
- ✓ Are there any third-party consents required to be obtained prior to undertaking the IPO?
- ✓ Does the company have an IPO preparedness plan to address all of its corporate governance requirements, as well as its public reporting obligations?
- ✓ Have the underwriters and the company agreed upon an underwriting arrangement that adequately reflects the company's needs and the current market conditions?
- ✓ Are there sufficient safeguards in place to avoid any communications violations?

Here's the Deal:

- Filing the registration statement is a crucial part of an initial public offering ("IPO"), and, during the filing period, the company must engage with the SEC Staff and respond to its comments with responsive amendments.
- After the preliminary prospectus has been distributed, the company should be prepared to complete its roadshow, marketing the proposed IPO.
- Once the registration statement is finalized, the company, underwriters and the other parties will need to prepare for the pricing and closing of the offering, which will typically take place in the two weeks after the commencement of the roadshow.
- Throughout the IPO process, a company should carefully consider what information is included in the registration statement in order to avoid material misstatements or omissions of fact in the registration statement, which may give rise to liability under the Securities Act.

What's the Deal?

One of the most important steps in completing an IPO is publicly filing the registration statement, marking the commencement of the post-filing period. Within the post-filing period, there is the pre-effective period, or "waiting period," which refers to the period from the date of filing of the registration statement to its "effective date." Subsequently, the post-effective period is the period from the date the registration statement has been "declared effective" by the Securities and Exchange Commission (SEC) to the completion of the offering.

Pre-Effective Period

During the pre-effective period, a company is permitted to make oral offers and certain written offers, but may not enter into binding agreements to sell the offered security. During the waiting period, marketing will typically begin, subject to the limitations of the Securities Act of 1933, as amended (the "Securities Act"). Once the SEC Staff comments on the registration statement have been resolved, or it is clear that there are no material open issues, the company and its underwriters will undertake a one- to two-week " roadshow" during which company management will meet with prospective investors. The length of the roadshow will vary depending on many factors. Underwriters commonly arrange for a number of test-the-waters meetings with potential institutional investors with the company. Often the underwriters will advise the company to delay a public filing of the registration statement until the underwriters have received positive feedback from these test-the-waters meetings. The test-the-waters meetings may limit the need for a long roadshow. Also, for a smaller offering, the roadshow may be shorter than for a larger offering and may be limited to domestic meetings. Of course, as a result of the COVID-19 pandemic, many roadshows are taking place virtually.

After the underwriters have assembled indications of interest for the offered securities, the company and its counsel will request that the SEC declare the registration statement "effective" at a certain date and time, usually after the close of business of the U.S. securities markets on the date scheduled for pricing of the IPO.

THE FILING PROCESS AND SEC REVIEW

The SEC's review of the registration statement is an integral part of the IPO process. Once a registration statement is filed, a team of SEC Staff members is assigned to review the filing. The team consists of accountants and lawyers, including examiners and supervisors. The SEC's objective is to assess the company's compliance with its registration and disclosure rules. In addition to assessing compliance with applicable requirements, the SEC considers the disclosures through the eyes of an investor in order to determine the type of information that would be considered material to an investor. The SEC's review is not limited to just the registration statement. The SEC Staff will closely review websites, databases, and magazine and newspaper articles, looking in particular for information that they think should be in the prospectus or that contradicts information included in the prospectus.

The review process is time-consuming. The review depends on the complexity of the company's business and the nature of the issues raised in the review process. Initial comments on Form S-1 are provided in about 30 days—depending on the SEC's workload and the complexity of the filing, the receipt of first-round comments may take longer. The SEC Staff generally tries to address response letters and amendments within 10 days, but timing varies considerably. This timing is the same whether the registration statement is filed publicly or submitted confidentially.

REGISTRATION STATEMENT

A registration statement contains the prospectus, which is the primary selling document, as well as other required information, written undertakings of the issuer and the signatures of the issuer and at least a majority of the issuer's directors. It also contains exhibits, including basic corporate documents and material contracts. U.S. companies generally file a Form S-1 registration statement, while most non-Canadian foreign private issuers use a Form F-1 registration statement, although other forms may be available. There are also special forms available to certain Canadian companies. A registration statement is filed electronically with the SEC through its Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system. Before the company can file via the EDGAR system, it must create an account with the SEC by obtaining a Central Index Key ("CIK") number and associated security codes. The CIK number is a unique number assigned to individuals and companies who file reports with the SEC. Once the company files the registration statement via the EDGAR system, it becomes publicly available.

In addition to a registration statement, a company is required to file certain exhibits with the registration statement, including its certificate of incorporation, bylaws, material agreements (including the underwriting agreement) and consents of experts. Since information filed via the EDGAR system with the SEC will be publicly available, if the company wants to keep any information confidential, it must file redacted versions of the exhibits with the SEC. Redactions should be based on information that may

involve trade secrets or commercial or financial information that could harm the company competitively if disclosed to the public.

FINANCIAL INFORMATION INCLUDED IN THE REGISTRATION STATEMENT

As part of filing the registration statement, the SEC rules require the following information in the prospectus of an issuer:

- Audited balance sheets as of the end of the issuer's last two fiscal years;
- Audited statements of operations, statements of cash flows, statements of comprehensive income and statements of changes in shareholders' equity of the company's last three fiscal years, or two years in the case of an emerging growth company (EGC); and
- Depending on the length of time from the end of the last fiscal year and the date of filing, an unaudited balance sheet for the most recent fiscal interim period and statements of operations, statements of cash flows and statements of changes in shareholders' equity for the interim period and for the corresponding period of the prior fiscal year.

These statements must be prepared in accordance with U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS) in accordance with the International Accounting Standards Board (IASB), and they will be the source of information for "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A"). In addition, a prospectus may contain audited and unaudited financial statements relating to acquisition of assets and companies as well as pro forma financial information giving effect to the acquisition.

The SEC will review and comment on the financial statements and the MD&A. The SEC's areas of particular concern are:

- Revenue recognition.
- Business combinations.
- Segment reporting.
- Financial instruments.
- Impairments of all kinds.
- Deferred tax valuation allowances.
- Compliance with debt covenants.
- Fair value.
- Loan losses.

Companies and their auditors should also review their accounting policies and potential areas of concern before filing the registration statement. The SEC encourages discussions with its accounting staff of accounting concerns early in the preparation process, thus avoiding potential problems once the registration statement is filed and publicly available.

PROSPECTUS

The prospectus describes the offering terms, the anticipated use of proceeds, the company, its industry, business, management and ownership, and its results of operations and financial condition. Although it is principally a disclosure document, the prospectus is also crucial to the selling process.

The principal sections of the prospectus are identified below ("smaller reporting companies," as defined by the SEC), EGCs and foreign private issuers have less onerous disclosure obligations, particularly with respect to executive compensation:

- **Summary.** The summary is a short overview of the more important aspects of the offering and the company. The summary will cover the type of security offered, a brief description of the company, the amount of securities offered, the trading market for the securities and the use of the proceeds.
- **Financial Statements.** The prospectus will include audited financial statements of the company, including balance sheets for each of the last two completed fiscal years and income statements for each of the last three completed fiscal years. The prospectus must also include unaudited financial statements for any interim periods subsequent to the last completed fiscal year.
- **MD&A.** The MD&A section describes the company's liquidity, capital resources and results of operation. It also includes a discussion of known trends and uncertainties that may have a material impact on the company's operating performance, liquidity or capital resources. The SEC has identified three principal objectives of the MD&A section: (i) to provide a narrative explanation of the company's financial statements enabling investors to view the company through management's eyes; (ii) to enhance the overall financial disclosure and provide context within which the company's financial information should be analyzed; and (iii) to provide information about the quality of, and potential variability of, the company's earnings and cash flow, so that investors can assess the company's future performance.
- **Risk Factors.** The risk factors section usually includes risks pertaining to the offering; risks pertaining to the issuer; and risks pertaining to the issuer's industry. The SEC requires that the risk factors section include only risks specific to the company.
- **Business.** The business section describes the company's business, including its products and services, key suppliers, customers, marketing arrangements and intellectual property.
- **Management.** Officers and directors must be identified in the management section and brief biographical descriptions must be included.
- **Executive Compensation.** The company must disclose the executive compensation of its five highest paid executive officers, which must include the CEO and CFO. Most of this disclosure is presented in tabular format. The executive compensation section must also include directors' compensation and employee benefit plans. The SEC requires a compensation disclosure and analysis in which the company discloses the company's executive and board compensation matters. An EGC will have reduced compensation disclosure requirements.
- **Related Party Transactions.** This section must include any material business transaction between the issuer and its executive officers, directors, significant shareholders and other key personnel.

- **Security Ownership.** This section includes a tabular presentation of the company's officers' and directors' beneficial share ownership as well as the beneficial ownership of each holder of more than 5% of the company's outstanding stock.
- **Plan of Distribution.** The plan of distribution section describes the underwriting arrangements, including the underwriters' plans for distributing the shares in the offering.
- **Counsel and Experts.** These two sections identify counsel to the company and the underwriters and the accountants who have audited the company's financial statements. "Experts" will also identify any other entity that has "expertized" any information in the prospectus.

A prospectus should not include "puffery" or overly optimistic or unsupported statements about the company's future performance. Rather, it should contain a balanced discussion of the company's business, along with a detailed discussion of risks and operating and financial trends that may affect its results of operations and prospects.

SPECIFIC DISCLOSURES REQUIRED FOR AN EGC

The JOBS Act has created an "on-ramp" of scaled disclosure requirements for EGCs. Generally, an EGC will have the flexibility to choose the scaled disclosures with which it can comply, with the exception of complying with new or revised accounting standards on time.

- **Financial Statements and MD&A.** An EGC is required to present only two years of audited financial statements in its IPO registration statement. An EGC may also limit its MD&A to cover only those audited periods presented in the audited financial statements. The SEC will also not object if an EGC presenting two years of audited financial statements limits the selected financial data included in its IPO registration statement to only two years. An EGC should consider, together with its advisors, whether it makes strategic sense to include additional years of financial information.
- **Executive Compensation.** An EGC may comply with the executive compensation disclosures applicable to a "smaller reporting company," which means that an EGC need provide only a Summary Compensation Table (with three rather than five named executive officers and limited to two fiscal years of information), an Outstanding Equity Awards Table and a Director Compensation Table, along with some narrative disclosures to augment those tables. EGCs are not required to provide a Compensation Discussion and Analysis or disclosures about payments upon termination of employment or change in control.
- **Compliance with new or Revised Accounting Standards.** An EGC may elect an extended transition to compliance with new or revised accounting standards. However, if an EGC chooses to comply with such standards to the same extent that a non-EGC is required to comply with such standards, the EGC must (1) make such choice at the time it is first required to file a registration statement, periodic report or other report under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and notify the SEC of such choice; (2) comply with all such standards to the same extent that a non-EGC is required to comply with such standards; and (3) continue to comply with such standards to the same extent that a non-EGC is required to comply with such standards for as long as the company remains an EGC.

- **EGC Status.** The SEC Staff has explained that an EGC must identify itself as an EGC on the cover page of its prospectus. In addition, SEC Staff comments on EGC registration statements have requested the following disclosures:
  - (i) A description of how and when a company may lose EGC status.;
  - (ii) A brief description of the various exemptions available to an EGC, such as exemptions from Section 404(b) of the Sarbanes-Oxley Act and the Say-on-Pay/Say-on-Golden Parachute provisions; and
  - (iii) The EGC's election for extended transition to new or revised accounting standards.

The SEC Staff requests that if the EGC has elected to opt out of the extended transition period for new or revised accounting standards, then it must include a statement that the election is irrevocable. If the EGC has elected to use the extended transition period, then risk factor disclosure must explain that this election allows an EGC to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. The SEC Staff requests the EGC state in the risk factors that, as a result of this election, the EGC's financial statements may not be comparable to issuers that comply with public issuer effective dates. A similar statement is also requested in the EGC's critical accounting policy disclosures in MD&A.

Post-Effective Period

The post-effective period is the period from the date the registration statement has been "declared effective" by the SEC to the completion of the offering. In the majority of IPOs, after the roadshow, representatives of a company and its underwriters will meet to price the offering. The IPO price will be determined based on the demand for the stock, current market conditions and the price range stated in the preliminary prospectus. If the number of shares will be significantly increased or decreased or the offering will not be priced within the range, a free writing prospectus is often issued at this point to make sure that investors have the necessary information before deciding to purchase the shares. Additional information will also be determined at this time, including the underwriters' fees and commissions.

After the offering is priced, the issuer and its managing underwriters execute the underwriting agreement, and the auditor delivers the executed comfort letter. The company will proceed to file a final prospectus with the SEC that contains the final offering information. On the second or third business day following the pricing transaction, the closing occurs, the shares are issued and the issuer receives the proceeds. The closing completes the offering process. Then, for the next 25 days, aftermarket sales of shares by dealers must be accompanied by a final prospectus or a notice with respect to its availability. If during this period there is a material change that would make the prospectus misleading, the company must file an amended prospectus.

PRICING

The IPO price will be determined based on the demand for the stock, current market conditions and the price range stated in the preliminary prospectus. If the number of shares will be significantly increased or decreased or the offering will not be priced within the range, a free writing prospectus is often issued at this point to make sure that investors have the necessary information before deciding to purchase the shares.

Most "firm commitment" equity public offerings include an "over-allotment option" or "green shoe" (the latter name references a case about these kinds of options). This option enables the underwriters to purchase additional shares (usually 15% of the "firm" shares purchased by the underwriters) from the company if there is substantial demand for the offered shares. The option is typically exercisable for 30 days after the pricing of the IPO and the underwriters may purchase the additional shares at the same price per share as those sold in the IPO.

CLOSING

The closing of the offering usually takes place two or three business days (T+2 or T+3) after the pricing of the IPO, typically T+3 because offerings are usually priced after the close of the market. Immediately prior to the closing, the underwriters will also hold a bring-down diligence call with the company to confirm that no material changes in the company's business or finances have occurred since the date of pricing and that the statements in the prospectus remain accurate. At the closing, the company will deliver the documents required by the underwriting agreement, including a bring-down comfort letter, certificates of officers and one or more opinions of counsel. Upon satisfaction of the closing conditions, the underwriters will wire transfer the net proceeds of the offerings to the company and upon receipt, the company will instruct its transfer agent to release the shares to the underwriters.

Liability Concerns

One final important consideration, that a company should consider during an IPO, is the civil and criminal liability that may arise in connection with the registration statement when it becomes effective or in a preliminary prospectus upon which a contract for sale of shares of a company's stock is based. Liability can range from material misstatements or omissions in the registration statement or the failure to comply with registration requirements or to supply or make available a final prospectus to investors.

Purchasers of a company's stock in a registered public offering have a right of action under Section 11 of the Securities Act for an untrue statement of material fact or an omission to state a material fact in a registration statement. Section 11 imposes liability on the issuer, each person who signs the registration statement, each director, the company's accountants (and certain other experts) and the underwriters. Purchasers also have a right of action under Section 12(a)(2) for false or misleading statements that are material in a prospectus and in oral statements. The SEC may bring actions under Section 17 of the Securities Act and Section 10(b) and Rule 10b-5 under the Exchange Act.

If a company's registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated in it (or that is necessary to make the statements not misleading), any purchaser of the company's stock can sue the issuer and the following persons:

- Anyone who signed the registration statement (the registration statement is signed by the company's chief executive, principal financial and accounting officers, and at least a majority of the company's directors);
- Anyone who was a director of the issuer (or anyone who consented to be named as a director) at the time the registration statement was filed;

- Every accountant, engineer, appraiser or other expert who consented to be named as having prepared or certified the accuracy of any part of the registration statement or any report or valuation used in the registration statement (but liability is limited to that information); and
- Every underwriter.

A purchaser of a security can also sue any person who:

- Offered or sold the company's stock to that purchaser in violation of Section 5 of the Securities Act;
- Offered or sold the company's stock to that purchaser by means of a prospectus or oral communication that included an untrue statement of a material fact or omitted to state a material fact necessary to make a statement, in light of the circumstances under which it was made, not misleading; and
- Every person who controls (through share ownership, agreement or otherwise) any other person that is liable under Section 11 or 12 of the Securities Act is jointly and severally liable with that other person, unless the controlling person had no knowledge of, or reasonable grounds to believe in, the existence of the facts that resulted in the alleged liability.

Under the Securities Act, the company is absolutely liable for material misstatements or omissions in the registration statement, regardless of good faith or the exercise of due diligence. Directors and officers of the company, however, may have certain due diligence defenses, as do underwriters, the company's accountants and other experts and controlling persons. No person will serve as a director or officer without indemnification from the company and appropriate directors' and officers' insurance, and a company usually represents that it has such insurance in the underwriting agreement.

Since its early history, the SEC has consistently stated that indemnification of directors, officers and controlling persons for Securities Act liabilities is against public policy and is therefore unenforceable. Every registration statement is required to set forth the SEC's position. Nonetheless, companies have always provided such indemnification and courts have upheld such contract rights.

Checklist of Key Questions

- ✓ Will the company and its underwriters arrange test-the-waters meetings with institutional investors in advance of the IPO's roadshow?
- ✓ Has the company carefully considered the disclosure requirements applicable to it?
- ✓ Has the company considered the material contracts that will need to be publicly filed as exhibits to the IPO registration statement?
- ✓ Has the company reviewed available comment letters/responses from prior reviews from the SEC of peer companies in their preparation of the registration statement?
- ✓ In light of the projected timeline, has the company budgeted sufficient time for the filing, marketing, pricing and closing?
- ✓ Has the company taken the necessary precautions to mitigate liability concerns under the Securities Act and the Exchange Act?

Shelf Registration Statements and Shelf Takedowns

Here's the Deal:

- An effective shelf registration statement allows an issuer to be in a position to complete multiple offerings from time to time in the future without having the timing of any such offering delayed by a possible SEC review.
- In a continuous offering, issuers may offer securities promptly following the declaration of effectiveness of a shelf registration statement and do so pursuant to an offering program, such as a medium-term note program.
- Alternatively, when the issuer has no present intention to offer securities and intends to do so from time to time in the future in distinct offerings, the issuer will be said to be conducting a series of delayed offerings.
- A shelf registration statement may be used for a variety of types of offerings, including at-the-market offerings, depending on the issuer's needs.

What's the Deal?

The shelf registration process allows an issuer to file a registration statement with the Securities and Exchange Commission (SEC) in order to register a public offering, when the issuer has no present intention to sell the securities being registered. A shelf registration statement permits multiple offerings off of the same shelf registration statement, and it can be used for the sale of new securities by the issuer ("primary offerings"), the resale of outstanding securities held by securityholders ("secondary offerings") or a combination of both.

With an effective shelf registration statement, when the issuer wants to offer securities, it takes them "off the shelf." These "shelf takedowns" are usually offered pursuant to a base prospectus (contained in the registration statement) and a prospectus supplement. Securities are usually registered for sale either on a continuous or a delayed basis, although a portion of the securities may be offered immediately.

Benefits of a Shelf Registration Statement

The primary advantages of a shelf registration statement are timing and certainty. An effective shelf registration statement enables an issuer to access the capital markets quickly when necessary or when market conditions are optimal. As noted above, once an issuer's shelf registration statement has been declared effective, no SEC review is required in connection with subsequent takedowns.

When a specific offering is planned, a prospectus supplement that describes the terms of the offering must be filed with the SEC pursuant to Rule 424(b) under the Securities Act of 1933, as amended (the

"Securities Act") within the time period specified in the relevant provision of Rule 424(b) that is being relied on in connection with the supplement filing.

In the case of a shelf registration statement on Form S-3 (for U.S. issuers) or Form F-3 (for foreign private issuers), the registration statement may provide historical information by relying on incorporation by reference from the issuer's reports previously filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and also can incorporate Exchange Act reports that are filed by the issuer after the shelf registration statement's effective date. The ability to forward incorporate will allow the issuer to ensure that the shelf registration statement remains current, without having to undertake amendments.

Takedowns from an effective shelf registration can be made without SEC Staff review or delay. Unlike a post-effective amendment, a prospectus supplement does not have to be declared effective by the SEC Staff.

Differences Between a "Continuous" Offering and a "Delayed" Offering

In a "continuous offering," securities are offered promptly after effectiveness of the registration statement (within two days) and will continue to be offered from such date forward. The term "continuous" only applies to offers of the securities, not to sales of the securities, as sales may be made sporadically over the duration of the continuous offering.

By contrast, in a "delayed offering," there is no present intention to offer securities at the time of effectiveness. Generally, only more "seasoned" issuers that are "primarily eligible" to use Form S-3 or Form F-3 may engage in delayed primary offerings. In a delayed primary offering, the issuer typically will file a "core" or "base" prospectus as part of the initial filing of the registration statement. The actual terms and specifics of an offering will be filed after effectiveness of the shelf registration statement, in either a prospectus supplement (the most common method), a post-effective amendment or, where permitted, an Exchange Act report incorporated by reference into the registration statement.

Eligibility Requirements for Filing a Shelf Registration Statement

In order to be eligible to use Form S-3 or Form F-3, among other requirements, the issuer:

- Must have a class of securities registered under the Exchange Act (or must be required to file reports under Section 15(d) of the Exchange Act);
- Must have been subject to the reporting requirements of Section 12 or Section 15(d) of the Exchange Act for at least 12 calendar months immediately preceding the filing of the registration statement and have timely filed all required reports with the SEC during that period; and
- Since the end of the last year covered by its audited financial statements, cannot have failed to pay dividends or sinking fund installments on preferred stock or defaulted on installments on indebtedness for borrowed money or on material leases.

ISSUANCE OF NONCONVERTIBLE SECURITIES

An issuer is considered "primarily eligible" to use Form S-3 or Form F-3 if the aggregate market value of its voting and non-voting common equity held by non-affiliates (its "public float") is at least $75 million. As an alternative to the $75 million public float requirement, issuers may use Form S-3 or Form F-3 for

offerings of nonconvertible securities (other than common equity), if the issuer satisfies any one of the following criteria:

- The issuer has issued (as of a date within 60 days prior to the filing of the registration statement) at least $1 billion in nonconvertible securities, other than common equity, in primary offerings for cash registered under the Securities Act, over the prior three years;
- The issuer has outstanding (as of a date within 60 days prior to the filing of the registration statement) at least $750 million of nonconvertible securities, other than common equity, issued in primary offerings for cash registered under the Securities Act;
- The issuer is a wholly-owned subsidiary of a well-known seasoned issuer (WKSI); or
- The issuer is a majority-owned operating partnership of a real estate investment trust (REIT) that qualifies as a WKSI.

"BABY SHELF" ISSUERS

Smaller issuers with a public float of less than $75 million may also be primarily eligible to use Form S-3 or Form F-3 if the issuer:

- Meets the other eligibility requirements of the relevant Form;
- Is not and has not been a "shell company" for at least 12 calendar months prior to the filing of the Form;
- Has a class of common equity securities listed on a national securities exchange (*i.e.*, not the over-the-counter market or the "pink sheets"); and
- Does not sell in a 12-month period more than the equivalent of one-third of its public float (the "one-third cap").

However, an issuer with a public float that does not exceed the $75 million market value threshold may not sell more than the equivalent of one-third of its public float during any 12 consecutive months. The determination of the issuer's public float will be made 60 days prior to the proposed sale.

The aggregate market value of all securities sold during the 12-month period prior to the sale is calculated by using the price of all securities sold by the issuer under the applicable Form in the previous 12 months, whether debt or equity, including those to be sold in the proposed sale. For securities convertible into or exercisable for equity securities ("derivative securities"), issuers will calculate the amount that they may sell in any 12-month period by reference to the market value of the underlying shares as opposed to the market value of the derivative securities. The one-third cap will not impact a holder's ability to convert or exercise derivative securities once a derivative security has been properly issued under the test, even if the issuer's public float decreases.

After all or any portion of the derivative securities are exercised or converted, in order to determine the amount of any securities that may be issued under the one-third cap in addition to any of the derivative securities that remain unexercised, the value of the exercised or converted portion will be calculated by multiplying the number of underlying shares issued by the market price on the date of conversion. Because the calculation of the one-third limitation depends on the issuer's public float at any point in time, an issuer's ability to use its shelf registration statement may increase or decrease during the life of the shelf. Increases to an issuer's public float will increase its "shelf capacity"; decreases to its public float will decrease its "shelf capacity."

Ineligible Issuers

An ineligible issuer is an issuer for which any of the following is true:

- The issuer has not filed all reports required to be filed during the preceding 12 months (or any shorter period for which the issuer has been required to file);
- The issuer is or, during the past three years, was a "blank check company" or a shell company or offered penny stock;
- The issuer is a limited partnership offering securities other than through a firm commitment underwriting;
- The issuer was the subject of a bankruptcy proceeding within the past three years;
- Within the past three years the issuer (or any subsidiary) was convicted of any felony or misdemeanor under Section 15(b)(4)(b) of the Exchange Act;
- Within the past three years the issuer (or any subsidiary) was the subject of any judicial or administrative decree or order arising out of a governmental antifraud action;
- The issuer filed a registration statement that is the subject of any pending proceeding or examination under Section 8 of the Securities Act (which relates to misleading or incomplete registration statements) or was the subject of any refusal order or stop order within the past three years; or
- The issuer is the subject of any pending proceeding under Section 8A of the Securities Act in connection with an offering.

The SEC has the power under its rules to determine, upon a showing of good cause, that it is not necessary under certain circumstances for an issuer to be considered an ineligible issuer.

Qualifying as, and the Benefits of Being, a WKSI

QUALIFYING AS A WKSI

In order to qualify as a WKSI, an issuer will be required to file reports with the SEC under Section 13(a) or Section 15(d) of the Exchange Act and satisfy the following requirements:

- It must meet the registrant requirements of Form S-3 or Form F-3 (*i.e.*, it must be a "primarily eligible" issuer);
- It must, as of a date within 60 days of filing its shelf registration statement, either:
  - Have a worldwide market value of its outstanding voting and non-voting common stock held by non-affiliates of $700 million or more; or
  - Have issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities in registered primary offerings for cash; and

- It must not be an "ineligible issuer."

A majority-owned subsidiary of a WKSI will itself be a WKSI in connection with:

- Its issuance of non-convertible investment grade securities that are fully and unconditionally guaranteed by its parent; or
- Its issuance of guarantees of non-convertible securities of its parent or of another majority-owned subsidiary whose non-convertible securities are so guaranteed by the WKSI parent.

If the majority-owned subsidiary is itself a WKSI by reason of its issuance of $1 billion or more of nonconvertible securities and also meets the test of a primarily eligible issuer, the subsidiary may register an offering of its common stock or other equity securities as a WKSI, filing an automatic shelf registration statement.

BENEFITS OF WKSI STATUS

A WKSI may take advantage of a more flexible automatic registration process. If a WKSI checks the applicable box on the cover of a registration statement (including a shelf registration statement) on Form S-3 or Form F-3, for either a primary or secondary offering or a combination, the registration statement will automatically be effective upon filing. Therefore there will be no delay in effectiveness.

A WKSI will also have the ability to:

- Register unspecified amounts of different types of securities;
- Register additional classes of securities and eligible majority-owned subsidiaries as additional registrants after effectiveness by filing a post-effective amendment that also will be automatically effective upon filing;
- Exclude additional information from the base prospectus, including:
  - Whether the offering is a primary or secondary offering;
  - A description of the securities, other than the name or class of securities (*i.e.*, "debt," "common stock" and "preferred stock");
  - The names of selling securityholders and the amounts of securities to be offered by each; and
  - Disclosure regarding the plan of distribution;
- Pay filing fees on a "pay-as-you-go" basis at the time of each takedown; and
- Use "free writing prospectuses" relating to an offering before the registration statement is filed.

Shelf Registration Filing Requirements

An issuer must include the undertakings set forth in Item 512(a)(1) of Regulation S-K in its shelf registration statement filing. These undertakings include the duty to update the prospectus under Section 10(a)(3) of the Securities Act to reflect fundamental changes and changes in the plan of distribution. Issuers also must undertake to deregister any unsold securities at the end of the offering. An issuer must also agree that, consistent with Rule 430B and Rule 430C, information in the prospectus supplement is deemed part of and included in the applicable registration statement as of specified dates (generally the earlier of the date the prospectus supplement is first used or the date of the first contract of sale for securities in the offering described in the prospectus supplement). Further, for liability purposes of the issuer and any underwriter, that date will be deemed the new effective date of the registration statement relating to the securities to which that prospectus supplement relates.

A post-effective amendment is required instead of a prospectus supplement when:

- There is a "fundamental change" (a higher threshold than "material") to the disclosure;
- The disclosure in the registration statement has to be updated for Section 10(a)(3) purposes; or
- There is a change to the plan of distribution (*e.g.*, switching to an "at-the-market" offering from a firm commitment offering).

However, the undertaking to file a post-effective amendment in these instances will not apply if the registration statement is on Form S-3 or Form F-3, and the required information is contained in an Exchange Act report (including a Current Report on Form 8-K) that is incorporated by reference in the registration statement or is contained in a prospectus supplement filed pursuant to Rule 424(b).

In a delayed primary shelf offering, the specific terms of the offering (*e.g.*, price, number of securities, etc.) are usually provided in a prospectus supplement filed under Rule 430A of Regulation C. Accordingly, a post-effective amendment to the registration statement is not needed.

Incorporation by reference occurs when disclosure in one filed document is legally deemed to be included in another document. A Form S-3 or Form F-3 allows a company to incorporate by reference the disclosure from its current and future Exchange Act reports to satisfy the disclosure requirements of the Form.

Limitations on a Shelf Registration Statement

Offerings under Rule 415(a)(1)(x) and continuous offerings under Rule 415(a)(1)(ix) that are registered on Form S-3 or Form F-3 are not subject to the two-year limitation on the amount of securities that can be registered, but a shelf registration statement can only be used for three years (subject to a limited extension) after its initial effective date. Under the current rules, new shelf registration statements must be filed every three years (the three-year period begins on the initial effective date of the shelf registration statement), with unsold securities and fees paid under an "expiring" registration statement rolled over to the new registration statement where it relates to:

- Offerings by WKSIs on an automatic shelf registration; or
- Offerings described in Rule 415(a)(1)(vii), (ix) or (x).

The three-year time limitation was adopted because the SEC believes that the precise contents of shelf registration statements may become difficult to identify over time (since many different documents may be incorporated by reference) and that markets will benefit from a periodic updating and consolidation requirement. The two-year limitation on the amount of securities that may be registered continues to apply to business combination transactions under Rule 415(a)(i)(viii) and continuous offerings under Rule 415(a)(i) and (ix) not registered on Form S-3 or Form F-3.

Some other types of shelf registration statements are not subject to the three-year limitation, including:

- Registration statements to be used only for secondary offerings by selling securityholders; and
- Acquisition shelf registration statements.

In the case of shelf registration statements other than automatic shelf registration statements filed by WKSIs, as long as the new shelf registration statement is filed within three years of the original effective date of the old registration statement, the issuer may continue to offer and sell securities from the old registration statement for up to 180 days thereafter until the new registration statement is declared effective. The 180-day extension does not apply to automatic shelf registration statements, which are effective immediately upon filing.

Prior to the effectiveness of the new shelf registration statement, the issuer can amend it to include any securities remaining unsold from the old registration statement. The SEC filing fees attributable to those securities may be rolled over to the new registration statement. In addition, continuous offerings commenced under the old registration statement prior to the end of the three-year period may continue on the old registration statement until the effective date of the new registration statement if these offerings are permitted to be made under the new registration statement.

For WKSIs, as long as the issuer remains a WKSI, the new shelf registration statement will be effective immediately upon filing. The issuer may elect to include on the new registration statement any unsold securities covered by the old registration statement and SEC filing fees paid attributable to those securities.

Shelf Eligibility and Volatile Markets

In order to remain eligible to use a Form S-3 registration statement, neither the issuer nor any of its consolidated or unconsolidated subsidiaries shall have failed to pay any dividend on its preferred stock since the end of the last fiscal year for which audited financial statements are included in the registration. However, if an issuer's board of directors does not declare a dividend on non-cumulative preferred stock, the issuer is not disqualified from using Form S-3 since no liability to pay the dividend arises under the terms of the non-cumulative preferred stock. Conversely, a declared but unpaid dividend on non-cumulative preferred stock would disqualify the issuer from using Form S-3, as would the existence of accrued and unpaid dividends on cumulative preferred stock. The issuer would also be disqualified from using Form S-3 even if it has a history of accumulating such dividends for three quarters before paying them at the end of each year. However, if the cumulative preferred stock was issued as part of a trust preferred financing and the terms of the underlying debt permit the issuer to defer interest payments for a specific time period and such deferral is not considered a default under the financing, then the issuer may correspondingly defer the accrued dividend payment on the cumulative preferred stock without losing its eligibility to use Form S-3.

As a result of the market volatility caused by the COVID-19 pandemic, certain issuers may lose their status as WKSIs following the effective date of their shelf registration statements. As discussed above, an issuer qualifying as a WKSI may typically file an automatic shelf registration statement with the SEC. A WKSI is defined as an issuer that, among other things, as of a determination date, had a public float of at least $700 million. The "determination date" used to assess an issuer's WKSI eligibility may be any date within

60 days before the filing of (i) the shelf registration statement; (ii) the issuer's most recent post-effective amendment to a previously filed shelf registration statement; or (iii) its most recent Annual Report on Form 10-K or Form 20-F (in the event the issuer has not filed a shelf registration statement or a post-effective amendment for 16 months). An issuer does not need to have a $700 million public float at the time its automatic shelf registration statement is filed so long as it did reach such threshold within the 60-day period prior to the filing. A former WKSI will be required to amend its automatic shelf registration statement by filing a post-effective amendment on Form S-3 to convert the automatic shelf registration statement to a regular shelf registration statement. Given that WKSIs also are entitled to other benefits and accommodations, including certain communications-related safe harbors, the issuer should consult closely with counsel.

Permitted Offerings Pursuant to a Shelf Registration Statement

Rule 415 lists the types of permitted shelf offerings, including:

- Resales by selling securityholders;
- Immediate, delayed and continuous offerings by an issuer on Form S-3 or Form F-3, including "at-the-market" offerings by the issuer;
- Securities offered and sold under dividend reinvestment and employee benefit plans;
- Securities underlying options, warrants, rights and convertible securities;
- Securities pledged as collateral;
- Depositary shares evidenced by American Depositary Receipts;
- Securities issued in business combinations;
- Mortgage-related and other investment grade asset-backed securities; and
- Offerings that commence promptly and are made on a continuous basis for more than 30 days.

All transactions registered on Form S-4 or Form F-4 are considered continuous offerings under Rule 415. An issuer can use a shelf registration statement for acquisitions. An issuer can use a shelf registration statement for one or more acquisitions, even if the targets are unknown at the time of filing. An issuer may also register securities for future issuance in connection with acquisitions on a delayed basis. These are known as "acquisition shelves." However, an automatically effective shelf registration statement may not be used as an acquisition shelf.

Liability Considerations

SECTION 11

Rule 430B and Rule 430C codify the SEC's position that the information contained in a prospectus supplement required to be filed under Rule 424, whether in connection with a takedown or otherwise, will be deemed part of and included in the registration statement containing the base prospectus to which the prospectus supplement relates. For prospectus supplements filed other than in connection with a takedown of securities, all information contained therein will be deemed part of and included in the registration statement as of the date the prospectus supplement is first used. For prospectus supplements

WHAT'S THE DEAL? SHELF REGISTRATION STATEMENTS AND SHELF TAKEDOWNS

in connection with takedowns, it is the earlier of the date the supplement is first used or the date and time of the first contract of sale for the securities.

REGULATION FD

In some cases, Rule 100(b)(2)(iv) of Regulation FD exempts offerings registered under the Securities Act, except offerings registered under Rule 415(a)(i)-(vi). In the case of an offering under Rule 415(a)(i)-(vi), the issuance and delivery of the registration statement, the prospectus and certain free writing prospectuses will not be deemed a violation of Regulation FD.

In general, ongoing and continuous offerings on behalf of selling securityholders will not be exempt from Regulation FD. However, continuous and ongoing offerings on behalf of selling securityholders that also involve a registered offering, whether or not underwritten, by the issuer for capital formation purposes will be exempt (because Rule 415(a)(i) pertains to resale transactions "solely on behalf" of selling securityholders).

For example, a registered underwritten offering that includes shares issued by the issuer and selling securityholders is exempt from Regulation FD, but a registered underwritten offering of only selling securityholders' shares is subject to Regulation FD. Accordingly, in the former case, an issuer free writing prospectus can be used without raising any Regulation FD concerns. However, in the latter case, the use of an issuer free writing prospectus must be evaluated in the context of Regulation FD. In adopting Regulation FD, the SEC has expressed its concern that, because registration statements involving only secondary sales are often effective and used for a very long period, an issuer could be effectively exempt from Regulation FD if the exclusion for registered offerings covered them.

UNDERWRITER DUE DILIGENCE

Rule 176 under the Securities Act sets forth the factors to determine whether a reasonable investigation or reasonable grounds for belief under Section 11(c) of the Securities Act exist, under which an underwriter's due diligence defense is available. These factors include:

- The type of issuer;
- Reasonable reliance on officers, employees and others whose duties should have given them knowledge of particular facts; and
- With respect to facts or documents incorporated by reference, whether the particular person had any responsibility for the facts or documents at the time of the filing from which it was incorporated.

Checklist of Key Questions

- ✓ Is the issuer planning to sell new securities or outstanding securities?
- ✓ Are securities being immediately offered after the registration statement becomes effective?
- ✓ Will the issuer choose to offer securities in a delayed primary offering?
- ✓ Is the issuer considered a well-known seasoned issuer?
- ✓ Is the issuer subject to the baby shelf limitation?
- ✓ Is the issuer considering using a shelf registration for one or more acquisitions?
- ✓ Will the issuer be required to file a post-effective amendment as opposed to a prospectus supplement?

Private Investment in Public Equity Transactions

Here's the Deal:

- A private investment in public equity (PIPE) transaction is a private placement undertaken by an already public company.
- Typically, the investors in PIPE transactions are institutional accredited investors and qualified institutional buyers (QIBs).
- The issuer engages a placement agent to identify investors, wall cross these investors and have the investors agree to certain confidentiality undertakings and to refrain from trading in the issuer's securities for a period of time. The subscription agreement between the issuer and each of the investors include, among other things, a commitment on the issuer's part to file and have declared effective, within particular time frames, a resale registration statement.
- The resale registration statement covers the resale from time to time of the securities purchased by the investors in the PIPE transaction.
- A PIPE transaction can be completed relatively quickly and efficiently and may be the best financing alternative in a number of instances.

What's the Deal?

A PIPE transaction refers to a private placement of a public issuer's equity or equity-linked securities to investors, where a resale registration statement covering the resale from time to time by the PIPE investors of the securities purchased in the PIPE transaction is made available by the issuer.

A PIPE transaction is marketed by the issuer's placement agent to potential investors that have been wall-crossed and that have agreed to confidentiality and a trading restriction. As a result, an issuer will be able to assess whether there is interest in a transaction on terms that are attractive to the issuer and to enter into definitive purchase agreements before the issuer makes any public announcement. This is important in order to avoid investor front-running among other things.

A PIPE transaction is structured as a private placement made pursuant to the Section 4(a)(2) statutory private placement exemption under the Securities Act of 1933, as amended (the "Securities Act"), and possibly Rule 506(b) of Regulation D.

Why a PIPE Transaction?

A PIPE transaction often is simply the most cost-effective alternative for many issuers especially during periods of heighted market volatility. While incurring substantially lower transaction expenses than it would in a public offering, an issuer will also expand its base of accredited and institutional investors through the PIPE transaction.

A PIPE transaction permits an issuer to raise capital quickly. Investors receive only very streamlined offering materials or information, including publicly filed Securities Exchange Act of 1934 ("Exchange Act") reports, unless there is a new, recent development or other material nonpublic information (MNPI).

As noted above, a PIPE transaction will be disclosed to the public only after definitive purchase commitments are received from investors and generally will close and fund within two to five days of receiving definitive purchase commitments. In a PIPE transaction, investors may expect a discount to the current market price to reflect the liquidity discount since initially investors receive "restricted securities" and will not have access to the resale registration statement for some period of time.

Comparing a PIPE Transaction with Other Financing Alternatives

In comparing a PIPE transaction against other potential financing options, an issuer should generally consider that:

- It is the investor, not the issuer, that bears the market risk,
- Sophisticated institutional investors are familiar, and the U.S. Securities and Exchange Commission (SEC) is comfortable, with the PIPE format,
- PIPEs typically involve a modest discount to market price,
- PIPEs do not have any of the negative effects often associated with a "death spiral" offering or an equity line of credit,
- Unless the PIPE is executed in connection with an acquisition or in a distressed environment, generally PIPE investors will not expect to have any ongoing affirmative covenants,
- Representations and warranties expected from the issuer will be quite consistent with those given by an issuer in its underwritten public offerings, and
- PIPE investors generally will not ask to and will not want to receive any MNPI (other than the mere fact that the issuer is contemplating a financing).

PIPE transactions may have some disadvantages, such as:

- The discount to the market price that the investors would require in order to compensate for the initial resale restrictions,
- The transaction may only be marketed to accredited investors,
- Certain investors will not agree to be wall-crossed,
- The issuer's inability to sell more than 20% of its outstanding stock at a discount without receiving prior stockholder approval, and
- A limit on the issuer's number of "blackout" (or suspension) periods while the resale registration statement is effective.

Participants in PIPE Transactions

Companies that are public reporting companies may consider a PIPE transaction.

The universe of potential investors is limited to accredited investors. Accredited investors include hedge funds, mutual funds, pension funds, sector and institutional buyers, venture funds and private equity firms. Distressed funds and venture funds have also begun participating in PIPE transactions.

There is no limit on the number of offerees in a PIPE transaction, so long as the placement agent is not engaging in any marketing or sales activity that would constitute a general solicitation.

The issuer will engage a placement agent to assist usually on an exclusive basis in identifying potential investors. The placement agent will play an essential role in wall crossing potential investors and ensuring that the investors agree to confidentiality undertakings before the name of the issuer is shared. The potential investors also will be required to agree to refrain from trading in the issuer's securities for a specified period of time.

Offering Materials

In a PIPE transaction, investors may receive a private placement memorandum; however, in many instances, the private placement memorandum will be quite limited and may contain principally the issuer's Exchange Act documents. Investors generally will not receive other MNPI.

Securities Offered in PIPE Transactions

In a typical PIPE transaction, investors enter into a purchase agreement that irrevocably commits them to purchase a fixed number of securities at a fixed price, not subject to market price or fluctuating ratios. Securities sold in a PIPE transaction are usually common stock, convertible preferred stock, convertible debentures, warrants, or other equity or equity-linked securities. Most PIPE transactions involve the sale of common stock at a fixed price, often with warrants.

Negotiation Points in PIPE Transactions

The price is set through discussions between the placement agent and the issuer, just as it is during the course of an underwritten (firm commitment) offering.

The price risk in a fixed priced transaction is borne by the purchaser during the period from execution of the purchase agreement until the closing.

The purchase agreement will contain a detailed set of issuer representations and warranties. These will cover matters relating to the authorization of the transaction and the issuance of the securities, the issuer's business and operations, the issuer's Exchange Act reports, the issuer's compliance with laws, non-contravention representations and related matters. The issuer's representations may be negotiated with potential investors.

The purchase agreement will contain representations and warranties from the investor generally relating to the investor's authority to enter into the transaction documents, the status of the investors, the sophistication of the investors, the reliance on the part of the investor's on their own diligence and on the issuer's Exchange Act filings, and related matters. The investor also will be asked to reaffirm its confidentiality undertaking and its covenant not to trade in the issuer's securities until the transaction is publicly disclosed and any other MNPI shared with the investor is disclosed.

The purchase agreement will contain numerous covenants on the issuer's part, including the covenant to file a resale registration statement. Investors will negotiate the time period for the initial filing of the resale registration statement and the time period for addressing any comments from the SEC to declare effective the resale registration statement. The investor will negotiate penalty payments for failure to meet any of the specified milestones. In addition, the investor also will negotiate limitations on the number of blackout periods and the length of such periods, as well as the period during which the resale registration statement must be kept effective. Finally, the investor may negotiate specific time periods in which the issuer will deliver an opinion to its transfer agent following the effectiveness of the resale registration statement to lift the restricted legend when the PIPE investor resells the securities.

The conditions to closing will not include any conditions that are within the purchaser's control. The issuer will be required to cause its counsel to deliver a legal opinion to the investors at closing.

Depending on the terms of the engagement letter between the issuer and the placement agent, the issuer may have other commitments to the placement agent, which may include a requirement to cause its counsel to deliver a reliance letter relating to the investor legal opinion.

The Resale Registration Statement

In connection with a PIPE transaction, an issuer typically must keep a resale registration statement effective for an agreed-upon period of time so that the securities may be sold freely, without reliance on Rule 144, by the PIPE investors. During this period, the issuer may suspend the use of the resale registration statement to amend it or to remedy a material misstatement or omission. This suspension is often referred to as a "blackout" period. During a blackout period, PIPE purchasers will have limited liquidity, as they will not be able to rely on the resale registration statement to sell the securities purchased in the PIPE transaction. Investors will negotiate a limit on the length and number of blackout periods.

If an issuer has a shelf registration statement on file, it is generally a primary shelf registration statement covering the sale by the issuer of its newly issued securities. The issuer must file and have declared effective a resale registration statement covering the resale by the PIPE purchasers (a selling stockholder shelf registration) from time to time of the securities that were purchased in the PIPE transaction.

The issuer does not need to be eligible to use a registration statement on Form S-3 ("Form S-3") on a primary basis in order to complete a PIPE transaction, but must be eligible to use Form S-3 on a resale basis.

The issuer may use a Form S-1 or a Form S-3 registration statement as a resale shelf registration statement in connection with a PIPE transaction. Nevertheless, an issuer should consider using a Form S-3, since it is more cost-effective and less time consuming than using a Form S-1 and is less burdensome and may be updated by the periodic filing of Exchange Act reports without the need to file post-effective amendments.

In order to use the Form S-3 for resales (secondary shares), an issuer must (1)(i) be organized and have its principal business operations in the United States or one of its territories; (ii) have a class of securities

WHAT'S THE DEAL? PIPE TRANSACTIONS

registered pursuant to Section 12(b) of the Exchange Act or a class of equity securities registered pursuant to Section 12(g) of the Exchange Act or be required to file reports pursuant to Section 15(d) of the Exchange Act; and (iii) have been public and have timely filed all required filings for a period of at least 12 calendar months immediately preceding the filing of the Form S-3 and have filed all required reports in a timely manner; and (2) the issuer and its consolidated and un-consolidated subsidiaries must not, since the end of the last fiscal year for which certified financial statements of the issuer and its consolidated subsidiaries were included in an Exchange Act report, (i) have failed to make any required dividend or sinking fund payment on preferred stock or (ii) defaulted on the terms of any borrowing or on any long-term lease, which defaults in the aggregate are material to the financial position of the issuer and its consolidated and unconsolidated subsidiaries, taken as a whole.

Regulatory Approvals

A PIPE transaction does not require any prior approvals from regulatory agencies or self-regulatory organizations if the issuer does not issue more than 20% of its pre-transaction total shares outstanding at a discount and if the transaction does not represent a change of control or otherwise trigger approval requirements.

The issuer and its counsel should consider carefully the applicable securities exchange rules. The issuer should consider not only the effect of completing the proposed PIPE transaction, but also, if the issuer has completed other private transactions within the same six-month period, the aggregate effect of such transactions, all of which may be aggregated by the exchange.

The New York Stock Exchange (NYSE), the NYSE American and Nasdaq have similar requirements, which we summarize briefly below, but which require a close look:

- Rule 312.03(c) of the NYSE Listed Company Manual requires that the issuer obtains shareholder approval prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if the common stock has, or will have upon issuance, voting power equal to, or in excess of, 20% of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock. Shareholder approval is not required under this rule if the common stock is sold in (a) any public offering for cash or (b) any other financing in which the company is selling securities for cash involving a sale of (i) common stock at a price at least the "minimum price" or (ii) securities convertible into or, exercisable for common stock if the conversion or exercise price is at least the "minimum price." "Minimum price" is defined as the lower of (i) the closing price of the issuer's common stock immediately before the execution of the transaction agreement and (ii) the average closing price of the issuer's common stock during the five days immediately preceding the transaction agreement.

- Section 713 of the NYSE American Company Guide requires that an issuer obtain shareholder approval for a transaction involving (1) the sale, issuance or potential issuance by the company of common stock (or securities convertible into common stock) at a "minimum price" which, together with sales by officers, directors or principal shareholders of the company, equals 20% or more of presently outstanding common stock or (2) the sale, issuance or potential issuance by the company of common stock (or securities convertible into common stock) equal to 20% or more of presently outstanding stock for a "minimum price." "Minimum price" is defined as the lower of (i) the closing price of the issuer's common stock immediately before the execution of the transaction agreement and (ii) the average closing price of the issuer's common stock during the five days immediately preceding the transaction agreement.

- Rule 5635 of the Nasdaq Listing Rules requires that an issuer obtain shareholder approval in connection with a transaction other than a public offering, involving the sale, issuance or potential issuance at a "minimum price" by the issuer of common stock (or securities convertible into or exercisable for common stock), which alone or together with sales by officers, directors or substantial shareholders of the issuer, equals 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance. Rule 5635(d)(1)(A) defines "minimum price" as a price that is the lower of (i) the closing price (as reflected on Nasdaq.com) immediately preceding the signing of the binding agreement; or (ii) the average closing price of the common stock (as reflected on Nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement.

Shareholder approval also may be required by the rules of the securities exchanges for a private placement completed in connection with an acquisition, a private placement that results in a change of control or a private placement involving related parties.

Traditional PIPE Transaction Compared to PIPE with Trailing Resale Registration Rights

While the PIPE format began with the so-called "traditional" PIPE transaction structure, which we describe below, most of the PIPE transactions that have been completed in recent years have taken the form of PIPE transactions with trailing resale registration statements.

A traditional PIPE transaction is a private placement of either newly issued shares of common stock or shares of common stock held by selling stockholders (or a combination of primary and secondary shares) of an already public company that is made through a placement agent to accredited investors wherein definitive purchase agreements are executed, the transaction is announced and the closing takes place only once the resale registration statement is to be declared effective by the SEC. Key differences are summarized on the next page.

Differences	Traditional PIPE Transactions	PIPE Transaction With Trailing Registration Rights
Structure	Through a definitive purchase agreement between the investors and the issuer in which the investors commit to purchase securities at a fixed price and the funding is conditioned on the availability of the resale registration statement.	Closing takes place promptly after entry into a definitive purchase agreement. The issuer has a post-closing obligation to file a resale registration statement and use its best efforts to have it declared effective.
Has control of the process	Placement agent. The placement agent conducts its own business and financial due diligence. Traditional PIPE purchasers generally do not negotiate for themselves ongoing negative covenants or covenants relating to information rights or corporate governance.	Placement agent or lead investor. Investors may limit their diligence to public filings.
Closing conditions (in general)	The issuer must update the representations and warranties made in the purchase agreement (which are similar to those contained in an underwriting agreement) and deliver a comfort letter and legal opinions (including a 10b-5 negative assurance relating to the private placement memorandum and the resale registration statement) to the placement agent; There can be no material adverse change since execution of the purchase agreement; and The SEC must have stated its willingness to declare the resale registration statement effective (which consequently makes available to investors a resale registration statement at the time of closing).	The purchase agreement contains standard representations and warranties (similar to those contained in an underwriting agreement), which will be brought down at closing. For resettable or variable deals, the purchase agreement also may contain covenants requiring the future issuance of additional securities by the issuer at no cost to the purchaser. The purchase agreement may, depending on the nature of the purchaser, contain ongoing covenants relating to corporate governance (board representation or observer rights, blocking rights, etc.) or information requirements (regular deliveries of public filings or other information to the purchaser). The issuer must deliver a comfort letter and legal opinions to the placement agent. Each investor must deliver to the issuer and the issuer's transfer agent a certificate as to the investor's compliance with the prospectus delivery requirements in order to obtain unlegended stock certificates in the future; and There can be no material adverse change since execution of the purchase agreement.
Mode of settlement	Outside of the Depository Trust Company (DTC) system.	Outside of the DTC system.

Other Legal Concerns in PIPE Transactions

REGULATION FD

The agents in a PIPE transaction (*e.g.*, the placement agent, accountants and other participants in the PIPE process) owe a duty of trust or confidence to the issuer. Inasmuch as the issuer does not share any information with potential investors that has not already been included in its Exchange Act reports, the fact that the issuer is contemplating a PIPE transaction may oftentimes by itself constitute MNPI and the issuer will not want to be forced to make a premature disclosure regarding a financing. Hence, in compliance with Regulation FD, the issuer should ensure that, before the placement agent reveals the issuer's name, the placement agent obtains an oral or written agreement from each potential purchaser it contacts that information shared will be kept confidential and that the agreement contains an explicit undertaking to refrain from trading in the issuer's stock. Considering that the issuer's contemplation of a PIPE transaction generally seeks to preserve its flexibility and only make a disclosure once definitive agreements have been executed, it is unlikely that an issuer will want to engage in any form of general solicitation, even if permissible.

REGULATION M

Since most PIPE transactions are considered "distributions" for Regulation M purposes, the placement agent participating in a PIPE transaction must file a Regulation M notice with FINRA and refrain from making a market in the issuer's securities during the applicable Regulation M "restricted period," which is either one or five days prior to the pricing (as opposed to the funding or closing of the transaction) depending on the average daily trading volume of the issuer's security.

SEC COMMENTS

The SEC Staff has issued comments to certain issuers (usually small cap issuers and issuers that have sold shares in excess of 33% of the total shares outstanding prior to the PIPE transaction, which is considered as "disproportionately large") that have filed resale registration statements to cover the resale of shares originally offered in a PIPE transaction, questioning the appropriateness to use a resale registration statement (rather than a primary registration statement) for those shares, especially for PIPE transactions involving convertible securities.

In these cases, the SEC will use the factors it outlined in its 1997 interpretative guidance and evaluate the facts and circumstances of the issuance and the resale registration statement by assessing (i) the amount of securities involved, (ii) how long the securities have been held, (iii) whether the investors are at market risk from the time they purchase the securities, (iv) the circumstances under which the securities were acquired, and (v) whether it appears the seller is acting as a conduit for the issuer. If the SEC finds that the private placement was properly completed, the issuer can proceed with the use of the resale registration statement. If the SEC disallows the resale registration statement to proceed, the issuer can cut back on the number of shares and then file a second resale registration statement for the shares that were cut back.

Transactions Not To Be Confused with PIPE Transactions

The following transactions are not to be confused with PIPE transactions:

- **Death spiral or toxic convert.** "Death spiral" or "toxic convert" refers to a privately placed convertible security that has a floating conversion ratio but without a floor. The conversion ratio of the security adjusts based upon the market price of the issuer's securities at some point in the future, usually at the time of conversion. Death spirals or toxic converts typically reset or adjust downward (to protect the investor) and not upward (to protect the company). Death spirals or toxic converts typically are priced at some discount to the company's closing bid price over a period of days preceding the pricing date. This price can be manipulated easily.
- **Equity line of credit.** Under an equity line of credit, the issuer enters into a purchase agreement with an investor pursuant to which the company has the right, during the term of the equity line and subject to certain conditions, to put its securities to the investor. Some equity lines of credit are completed using a shelf registration statement and others are completed as private placements with an obligation to register the resale of the securities sold under the equity line. Unlike PIPEs, these transactions can also result in ongoing and substantial dilution.
- **Registered direct transaction.** A registered direct offering is a public offering but some of its features are akin to a private placement (*i.e.*, sales to selected institutional investors by a placement agent). The offered securities in a registered direct transaction are sold pursuant to an effective registration statement. Investors receive a preliminary prospectus (or red herring) during the marketing phase and a final prospectus prior to closing. The offering closes through DTC and investors receive their shares through DTC rather than receiving physical certificates like they would in a PIPE transaction.

Checklist of Key Questions

- ✓ Are the issuer's Exchange Act filings current?
- ✓ What information will be shared with investors other than the mere fact that the issuer is considering a financing through a PIPE transaction?
- ✓ When will such information be cleansed, or will investors remain restricted from trading for a period of time?
- ✓ Will the issuer use any information other than its Exchange Act filings?
- ✓ Does the placement agent have appropriate information walls and training in place for personnel participating in PIPE transactions?
- ✓ Does the placement agent use a wall crossing script or an NDA?
- ✓ Will the transaction be structured as an at-market deal?
- ✓ What securities will be offered in the PIPE transaction? If there are warrants or convertible securities, have the parties considered the securities exchange rules?
- ✓ Has the issuer and its counsel had a discussion with the securities exchange?
- ✓ Has the issuer considered the time required to file a resale registration statement?
- ✓ Any concerns regarding a review by the SEC?
- ✓ Are there any concerns regarding the amount of securities that will be included in the resale registration statement?
- ✓ Has the issuer filed its supplemental listing application?
- ✓ Does the purchase agreement provide for any covenants that limit the company's activities?

Here's the Deal:

- Registered direct offerings (RDOs) are hybrid securities offerings, meaning that these offerings have some characteristics typically associated with private placements and some characteristics of public offerings.
- An RDO is a public offering usually made pursuant to an issuer's effective registration statement wherein a financial intermediary acts as a placement agent on a best efforts basis and identifies investors that purchase the registered securities from the issuer.
- RDOs are generally marketed and sold to a limited number of institutional investors, however, given that an RDO is a public offering, securities can also be sold to retail investors.

What's the Deal?

A registered direct offering, or RDO, is a public offering of securities that is sold on a best efforts basis (rather than on a firm commitment basis) by a placement agent that is engaged by the issuer to introduce the issuer to potential purchasers. The purchasers buy the securities directly from the issuer.

An RDO is generally marketed on a wall-crossed or confidential basis, usually to a select number of accredited and institutional investors. Given that an RDO is a public offering, securities may be offered and sold to retail investors. An issuer may find an RDO an attractive financing option if the issuer would like to test the market or conduct an offering without attracting much market attention but would rather not incur the liquidity discount often associated with a private placement, or PIPE, transaction. Given that an RDO is marketed to a limited number of investors, it may be less disruptive to the trading market for the issuer's securities than a fully marketed follow-on offering. Also, from time to time, an RDO may be used to issue and sell securities to one or to a handful of investors, which may include existing securityholders that may not be able to acquire restricted securities.

Structuring Alternatives

An RDO may be structured as (1) an *"any-or-all"* transaction, where the transaction will proceed to a closing regardless of the amount raised in the offering, (2) a *"minimum-maximum"* transaction, where a certain minimum amount of proceeds must be raised in order for the transaction to close and a maximum offering size also is indicated or (3) an *"all-or-none"* transaction, where all of the securities offered must be sold in order for the transaction to close.

If an RDO is structured as a minimum-maximum offering or as an all-or-none offering (not an any-or-all offering), the placement agent must set up an escrow account at a national bank in order to collect and hold the investor funds until the conditions for release are met pursuant to Rule 15c2-4 under the Securities Exchange Act of 1934 (the "Exchange Act").

Participants in an RDO

Companies that are reporting companies and that have an effective shelf registration statement may consider an RDO.

Generally, the issuer will retain a financial intermediary to act as the placement agent. The placement agent will act on a best efforts only basis. The placement agent will introduce the issuer to potential investors; however, the placement agent has no obligation to purchase any of the offered securities. Unlike a firm commitment underwritten offering, in which the underwriter purchases the securities and resells these to investors, in an RDO, the investors are purchasing directly from the issuer.

Generally, the placement agent will "wall cross" potential investors in order to gauge their interest in a transaction.

An issuer may conduct a registered direct offering without a placement agent; however, this is generally only the case when the investor or investors are existing securityholders or when the investors have approached the issuer directly (as a reverse inquiry) and expressed an interest in purchasing securities.

As noted above, to the extent that the RDO is subject to a contingency, and an escrow agent is required, the issuer and the placement agent will retain an escrow agent that is a national bank, which will establish an escrow account to hold investor funds.

Documentation

Generally, the issuer and the placement agent will enter into an engagement letter pursuant to which the issuer will retain the placement agent to act on an exclusive basis as its agent in connection with the proposed RDO. The letter will specify the placement agent's fee, which may include a percentage of the amount raised, as well as warrants. The engagement letter may also address expense reimbursements, tail provisions and other matters. Finally, the issuer will agree to indemnify the placement agent for losses arising in connection with certain matters.

At pricing, the issuer and the placement agent will enter into a placement agency agreement. The placement agency agreement will supersede the engagement letter. The placement agency agreement will contain provisions that are very similar to those that would be contained in an underwriting agreement. The issuer will make representations and warranties about the issuer and its business, make certain covenants pertaining to the offering, and indemnify the placement agent and certain of its affiliates from liabilities under the Securities Act of 1933, as amended, that may arise in connection with the offering.

Despite the fact that a registered direct offering is conducted on a best efforts, and not a firm commitment, basis, the placement agent nonetheless would be considered a statutory underwriter. As a result, the placement agent and its counsel would conduct a diligence review in connection with the proposed offering. In addition, and in order to bolster the placement agent's diligence defense, the placement agent would generally require as a condition to closing, and set out in the placement agency agreement, the delivery of a legal opinion by the issuer's counsel, as well as the delivery of a 10b-5 negative assurance letter, and a comfort letter in customary form delivered to the placement agent by the issuer's independent accountants. Of course, depending on the particular issuer and its industry, additional deliverables may be required. Often, in order for the issuer's accountants to deliver a comfort

letter, given that the placement agent is acting only on a best efforts basis, the placement agent may be required to deliver a representation letter. The representation letter to the accountants would state that the placement agent will conduct diligence that is consistent with the diligence that would be undertaken in connection with a firm commitment registered offering.

From time to time, institutional investors that are participating in an RDO will express an interest in having a separate subscription or purchase agreement between the investor and the issuer pursuant to which the issuer makes representations and warranties directly to the investor. This should be considered carefully. A definitive commitment to purchase cannot be entered into until pricing information has been made available and time of sale materials have been made available.

Offering Materials

Investors may receive offering materials, such as a free writing prospectus, preliminary prospectus or preliminary prospectus supplement. Often, an issuer and placement agent may use a preliminary prospectus or preliminary prospectus supplement but may defer filing it until closer to the filing deadline while the issuer and placement agent are discussing the potential offering with wall-crossed investors.

Certain issuers, such as master limited partnerships, may not use a free writing prospectus in connection with an agency public offering.

Securities Offered in an RDO

An RDO may be used to offer and sell any security—common stock, preferred stock or debt securities. An issuer may sell its own newly issued shares. A selling stockholder also may also use an RDO to sell its shares, either alone or with primary (issuer) shares.

The Registration Statement

For purposes of conducting an RDO, an issuer may file a "bullet" registration statement or rely on a shelf takedown.

- **Bullet registration statement.** An issuer that does not have an effective shelf registration statement must file either (1) a single purpose registration statement for the express purpose of conducting an RDO (a "bullet") or (2) a shelf registration statement. Once the Securities and Exchange Commission clears the registration statement, the issuer and the placement agent agree to conduct a registered direct offering and enter into a placement agency agreement. The issuer prepares and files a prospectus (or prospectus supplement) that describes the offering, and investors purchase the securities directly from the issuer.
- **Shelf takedown.** If the issuer has an already existing and effective shelf registration statement, it may choose to conduct a takedown pursuant to its shelf registration statement (a "shelf takedown"). Depending how the offering is marketed and sold, the issuer will prepare a preliminary prospectus supplement or a final prospectus supplement that describes the offering. The issuer and the placement agent also will enter into a placement agency agreement.

Is an RDO a Distribution?

A placement agent will sell the securities on a best efforts basis and, in doing so, can only engage in passive market making activities and cannot engage in market stabilizing transactions. Since an RDO is a best efforts agency deal, RDOs do not include an over-allotment option which relates principally to stabilizing in connection with a firm commitment offering. Nonetheless, an issuer may increase the offering size to meet any additional demand.

An RDO will usually constitute a "distribution" for purposes of Regulation M, given that the placement agent will use special selling efforts, and the amount of securities offered will often be significant.

As a result, the placement agent is subject to the trading restrictions of Regulation M and should be aware of the applicable restricted period for the issuer's securities and submit the required Regulation M filings with the Financial Industry Regulatory Authority.

For investors, it is important to note that Rule 105 of Regulation M would not apply since the offering is conducted on an agency basis.

Securities Exchange Rules and RDOs

An issuer considering an RDO should take into account the applicability of the rules of the securities exchange. Although an RDO is a public offering, it likely would not be considered a broadly distributed or "public offering" for purposes of the applicable securities exchange. To the extent that the RDO will result in an issuance of voting stock in excess of 20% of the issuer's pre-transaction total shares outstanding, and the offering is being completed at a discount to the market price, the transaction may require shareholder approval. In evaluating whether an RDO is a public offering for purposes of these rules, the securities exchanges will consider several factors, including, but not limited to, whether the offering is an underwritten (a firm commitment) offering, the nature of the marketing process, the number of offerees and the degree of investor control of the terms. In addressing this concern, an issuer may choose to limit the offering size and decide to offer shares of common stock and warrants in an "at market" offering (not at a discount).

Comparing an RDO with a PIPE Transaction

An RDO is a public offering but some of its features are akin to those of a private investment in public equity (PIPE) transaction. Since the placement agent may market a potential RDO as it would market a PIPE transaction (that is, by obtaining confidentiality undertakings until such time as an actual transaction is announced), RDOs are often (though mistakenly) referred to as "registered PIPEs." The following table provides some comparisons.

Differences	Registered Direct Offering	PIPE Transaction
Type of securities offering	Hybrid. Offering methodology has certain characteristics associated with a public offering and a private placement.	Private.
Typical investors	Any targeted investors, but commonly institutional accredited investors and qualified institutional buyers (QIBs).	Institutional accredited investors and QIBs.
Usual marketing material	Investors receive a preliminary prospectus (or preliminary prospectus supplement) during the marketing phase and a final prospectus or prospectus supplement prior to closing.	Investors may receive a private placement memorandum or rely on the issuer's public filings.
Purchase agreement between the issuer and each investor	Generally not needed.	Yes. Investors enter into a purchase agreement that irrevocably commits them to purchase a fixed number of securities at a fixed price.
Offering price affected by liquidity discount	No.	Yes.
Mode of settlement	Through the Depository Trust Company (DTC) system. Usually closes on a T+2 or T+3 basis.	Outside of the DTC system. Investors receive physical certificates.
When offered, securities may be transferred	Freely transferable.	Restricted securities, which may be resold in other exempt transactions or pursuant to an effective resale registration statement when available.

Checklist of Key Questions

- ✓ Are the issuer's Exchange Act filings current?
- ✓ What materials will be used to market the potential offering?
- ✓ Does the issuer's board of directors and pricing committee understand the RDO structure?
- ✓ Does the placement agent use a wall-crossing script or a non-disclosure agreement in order to approach potential investors?
- ✓ Is an escrow account needed based on the structure of the RDO?
- ✓ Have the parties considered the applicability of the securities exchange rules in the context of certain offerings in which more than 20% of the pre-transaction total shares outstanding will be sold at a discount?
- ✓ If there is no placement agent, has the issuer made arrangements for DTC settlement through the issuer's transfer agent?

At-the-Market Offerings

Here's the Deal:

- An "at-the-market" (ATM) offering is an offering of securities into an existing trading market for the securities at a price or prices related to the then-market price of the securities.
- ATM offerings are continuous offerings and provide issuers with a flexible way to raise modest amounts of capital with minimal market impact, at a low cost and with limited management involvement.
- ATM offerings are often utilized by issuers that have a frequent need to raise capital, whether to repay debt, fund the purchase price for a small acquisition or otherwise fund operations.

What's the Deal?

An ATM offering is a follow-on offering of securities utilized by publicly traded companies in order to raise capital over a period of time. In an ATM offering, an issuer sells newly issued shares into the trading market through a designated sales agent at prevailing market prices. These offerings are conducted pursuant to an equity distribution or sales agreement entered into between the issuer and one or more sales agents. The sales agent may act either on an agency (best efforts) or principal (firm commitment) basis; however, more often than not, transactions are undertaken on an agency basis.

Advantages of ATM Offerings

ATM offerings offer several advantages over traditional follow-on offerings, including:

- **Minimal market impact.** Issuers can quickly raise capital by selling newly issued shares into the natural trading flow of the market, without having to market and/or announce the offering. As a result, shares are able to "trickle" into the market without significant impact on stock price.
- **Flexibility.** Sales can be effected on an agency or principal basis, and the terms of each sale are agreed upon between the issuer and the sales agent, including the timing and size, at the issuer's discretion. This enables an issuer to match its issuances to its ongoing needs. For example, an issuer can implement a limit price below which sales will not occur and/or a percentage limitation on daily sales to reduce downward price pressure on its stock.
- **Low cost.** The distribution costs for ATM offerings (usually 1-3%) typically are lower than the fees associated with traditional follow-on offerings.
- **Minimal management involvement.** ATM offerings require no "roadshows."

- **Forward sale option.** Many ATM offerings have been structured to incorporate a forward sale option. A forward sale allows an issuer to sell its securities through the ATM offering at the current trading price without actually issuing any securities to satisfy the forward commitment until a future settlement date.

Disadvantages of ATM Offerings

ATM offerings tend to be substantially smaller than traditional follow-on offerings and may not be as useful to issuers seeking to raise a large amount of capital within a short period of time. There are ongoing costs associated with the maintenance of an ATM program, which may seem substantial if the issuer is not making ATM offerings regularly.

Required Filings with the Securities and Exchange Commission

An issuer must have an effective shelf registration statement on Form S-3 (or Form F-3 for foreign private issuers) on file with the Securities and Exchange Commission (SEC). The issuer can either (i) use an allocated portion of an already existing universal shelf registration statement specifically for ATM programs or (ii) prepare a new shelf registration statement specifically for an ATM program. If the issuer decides to use an already existing shelf registration statement, then the issuer must prepare a prospectus supplement specifically for the ATM program. The plan of distribution section included in the shelf registration statement, or in the related prospectus supplement, must describe the general terms of the ATM program, including the method of sale and commissions/fees to be paid by the issuer, and identify the sales agents that will participate in the ATM program.

Upon execution of the equity distribution or sales agreement governing the ATM program, the issuer will file with the SEC the prospectus supplement, as well as a current report on Form 8-K, which will include as an exhibit, the equity distribution or sales agreement. In addition, the issuer must report quarterly the number of shares sold under the ATM program, as well as the commissions paid and net proceeds to the issuer, either by means of a prospectus supplement or in the issuer's periodic reports.

Often an ATM program will allow the issuer to conduct block trades, which trades are effected at a fixed price. To the extent that an issuer conducts a block sale, it might consider and discuss with counsel whether a prospectus supplement relating to the transaction should be filed.

Eligibility

A public company is eligible to implement an ATM program if it has a public float of at least $75 million or satisfies certain other qualifying thresholds. A company that qualifies as a well-known seasoned issuer (WKSI) will have greater flexibility. A WKSI may file an automatically effective shelf registration statement and is not required to specify an aggregate dollar amount on the registration statement. As a result, a WKSI may access the market promptly after filing its registration statement. An issuer that is not a WKSI and that does not have an effective shelf registration statement will need to file a registration statement, which may be subject to SEC comment, that specifies the number of securities to be registered.

An issuer that has an aggregate market value of common equity held by non-affiliates of less than $75 million, will be subject to Instruction 1.B.6(a) of Form S-3, which limits the amount the issuer can offer to up to one-third of the public float during any trailing 12-month period. This one-third limitation will apply

to securities sold in any primary offering, including an offering made pursuant to the ATM program. For issuers that are subject to this "baby shelf" rule, the full amount available under an ATM program (even the portion that remains unsold) counts against the one-third limitation, which can be quite punitive.

To calculate the public float for purposes of S-3 eligibility, an issuer may look back 60 days and select the highest of the last sales prices or the average of the bid and ask prices on the principal exchange. The registration capacity for a baby shelf is measured immediately prior to the offering and re-measured on a rolling basis in connection with subsequent takedowns. The shelf availability for a particular takedown is measured as the current allowable offering amount less any amounts actually sold under the shelf registration statement in prior takedowns. Accordingly, the available offering amount will increase as an issuer's stock price increases and decrease as an issuer's stock price decreases.

Required Documentation

The equity distribution or sales agreement, entered into between the issuer and the sales agent(s), establishes the terms and conditions upon which the issuer and sales agent will conduct the ATM offering. The agreement typically provides for both agency and principal transactions, sets forth the sales agent's commission, and contains representations, warranties and covenants from the issuer to the sales agent, as well as indemnification, contribution and termination provisions. The equity distribution or sales agreement typically terminates on either a fixed date or when the offering amount is reached.

The equity distribution or sales agreement usually requires the delivery to the sales agent of legal opinions (including a negative assurance from issuer's and agent's counsel), an officer's certificate and a comfort letter from the issuer's independent auditors. Generally, the agreement also will require that the issuer bring-down its representations and warranties at the time of each sale, as well as periodic updates to the issuer's deliverables to the sales agent.

Due Diligence Obligations

An ATM offering is a registered public offering. The sales agent and its counsel will conduct due diligence prior to the entry into the equity distribution or sales agreement and the commencement of the ATM offering. As discussed above, given the ongoing or continuous nature of the offering, the equity distribution or sales agreement will require that the issuer refresh or provide updated deliverables, including updates to the legal opinions and comfort letter.

The sales agent may be subject to liability under Section 11 of the Securities Act of 1933, as amended, even though it may be acting as an agent only on a best efforts basis, which means that the level of due diligence required is the same as that for any underwritten follow-on offering.

Executing ATM Sales

The sales agent generally will execute sales of the issuer's securities through ordinary brokers' transactions through securities exchanges or electronic trading systems at varying prices. These transactions do not involve any special selling efforts (*i.e.*, no roadshow or other active solicitation) nor do they involve an amount of the issuer's securities that would be considered significant relative to the issuer's public float or daily trading volume. The commission payable by the issuer to the sales agent is consistent with the commission payable to a dealer executing trades rather than the type of fee that would be associated with underwriting compensation. Based on these various factors, the sales agent's execution of ATM offerings more closely resembles ordinary dealer activity than participation as an underwriter in a securities distribution.

Regulation M

Regulation M is intended to prohibit manipulative practices in the securities offered in a distribution. Rule 101 of Regulation M prohibits distribution participants and their affiliated purchasers from directly or indirectly bidding for, purchasing or attempting to induce another person to bid for or purchase the subject security or any reference security until the applicable restricted period has ended. Rule 102 of Regulation M prohibits issuers, selling securityholders and their affiliated purchasers from directly or indirectly bidding for, purchasing or attempting to induce another person to bid for or purchase the subject security or any reference security until the applicable restricted period has ended.

An ATM offering of securities that qualify as "actively traded" (*i.e.*, average daily trading volume (ADTV) of at least $1 million for an issuer with a public float of at least $150 million) is not subject to the restrictions of Rule 101. However, the restrictions of Rule 102 still apply to the issuer, any selling securityholders and affiliated purchasers, unless the subject security is not issued by the issuer or any affiliate and the subject security has a reference security that itself qualifies as "actively traded." Generally, most ATM offerings are conducted for issuers that meet the ADTV test. In the case of securities that do not meet this exception, it will be important to undertake a closer analysis of the Regulation M restrictions.

Note that Rule 104 of Regulation M prohibits stabilization activities in connection with ATM offerings. In addition, ATM offerings are "best efforts" offerings, which are exempt from the short sale restrictions of Rule 105 of Regulation M.

FINRA requires sales agents to file Regulation M Restricted Period Notification Forms and related Regulation M Trading Notification Forms if the relevant transaction is considered a "distribution" as defined in Regulation M. In most cases, as discussed above, because the issuer's securities qualify as "actively traded," a restricted period is not imposed. However, to determine whether a proposed ATM offering is considered a distribution, Regulation M requires an analysis of factors that may distinguish the proposed offering from ordinary trading activity, such as the magnitude of the offering, the presence or absence of special selling efforts and methods, the number of shares to be sold, the percentage of outstanding shares of the proposed offering compared to the public float and the security's normal trading volume.

Rule 10b5-1 Plans

An affiliate of an issuer may utilize a Rule 10b5-1 trading plan in conjunction with an ATM offering as a means of disposing of its securities. Any person or entity executing preplanned transactions pursuant to a Rule 10b5-1 plan that was established in good faith at a time when that person or entity was not aware of material nonpublic information has an affirmative defense against accusations of insider trading, even if actual trades made pursuant to the plan are executed at a time when the individual or entity may be aware of material nonpublic information.

In order to benefit from the safe harbor, a Rule 10b5-1 plan incorporated into an ATM offering must:

- Specify the amount, price (which may include a limit price) and specific dates of purchases or sales; or
- Include a formula or similar method for determining amount, price and date; and
- Give the sales agent the exclusive right to determine whether, how and when to make purchases and sales, as long as the sales agent does so without being aware of material nonpublic information at the time the trades are made.

Compliance Considerations for Sales Agents

Sales agents participating in an ATM program should consider, among other things, how to address their participation in an ATM program with respect to any restricted or watch lists. Using watch and restricted lists may permit the sale agent's compliance and legal departments to monitor the firm's activities relating to the issuer, including research activities, and initiate proper conflict resolution procedures.

A sales agent generally can participate in an ATM offering even if it already provides research coverage regarding the issuer or plans to provide such coverage in the future. Rule 139(a) of the Securities Act permits a sales agent that participates in a distribution of securities of an issuer meeting the eligibility requirements of Form S-3 to publish a "research report" regarding the issuer or any class of its securities without having the research report considered an "offer" or a non-conforming prospectus, provided that the research report is included in a publication distributed with reasonable regularity in the normal course of the sales agent's business. Additionally, the "research report" must include similar information, opinions or recommendations with respect to a substantial number of companies in the issuer's industry or subindustry or contain a comprehensive list of securities currently recommended by such sales agent and the research covering the issuer is given no materially greater space or prominence than that given to other securities or companies.

In those instances where the sales agent does not already provide research coverage, a question may arise whether the sales agent can commence research coverage during the term of the ATM offering. Since there is little guidance to rely on, it is helpful to analogize and rely on the regulatory guidance regarding the commencement of research coverage preceding a follow-on public offering. A FINRA member cannot publish a research report on an issuer for which the FINRA member acted as a manager or co-manager of a follow-on offering by the issuer for three calendar days following the date of the offering. In this case, the sales agent may consider instituting a policy that it will not commence research coverage or provide a research report for a period of not less than three calendar days following the establishment of an ATM offering.

Sales agents must consider and institute guidelines regarding the review process that should be undertaken regarding research on the securities of issuers for which it is acting as an agent. These guidelines should include procedures for handling research reports that discuss earnings projections or a change in credit rating, as well as those reports issued outside the sales agent's regular course of business.

Checklist of Key Questions

- ✓ Does the issuer have enough authorized and unissued shares to accommodate the number of shares that may be issued in connection with the ATM offering?
- ✓ Is there a shelf registration statement available or must a new registration statement be filed?
- ✓ Is the issuer subject to Form S-3's baby shelf limitation?
- ✓ Will the ATM offering program include multiple sales agents?
- ✓ Will the ATM program be structured to incorporate the ability to undertake block sales?
- ✓ What are the quarterly diligence deliverables that are expected in connection with the ATM offering?
- ✓ What restrictions does Regulation M impose on the issuer and the sales agent?
- ✓ Has the issuer considered whether a forward sales agreement would be useful in connection with the ATM offering?

Here's the Deal:

- Rule 144A is an exemption from the registration requirements of Section 5 of the Securities Act of 1933 (the "Securities Act") for offers and sales of qualifying securities by persons other than the issuer of the securities.
- As a condition of the Rule 144A exemption, the resale must be made only to a qualified institutional buyer (QIB) or to a purchaser that the reseller (and any person acting on its behalf) reasonably believes to be a QIB, and the reseller must take reasonable steps to ensure that the purchaser is aware that the reseller is relying on Rule 144A in connection with the resale.
- Not all securities are eligible for resale pursuant to Rule 144A. Securities offered in reliance on Rule 144A must not be "fungible" with, or substantially identical to, a class of securities listed on a national securities exchange or quoted on an automated inter-dealer quotation system. Issuers must also be willing to provide or make available certain reasonably current information about the issuer to any purchasers.
- Rule 144A transactions may include (1) offerings of debt, convertible debt or preferred securities by public companies; (2) offerings by foreign issuers that do not want to become subject to U.S. reporting requirements; and (3) offerings of common stock by non-reporting issuers (*i.e.*, "backdoor IPOs").
- Rule 144A is an attractive option for continuous offering programs, particularly those that offer complex securities and are not aimed at retail investors.

What's the Deal?

Every security offered or sold in the United States must either be registered with the U.S. Securities and Exchange Commission (SEC) under Section 5 of the Securities Act or must qualify for an exemption from such registration requirements. The Rule 144A exemption applies to resales to QIBs of qualifying securities by certain persons other than the issuer of the securities. Resellers that rely on the exemption are not "underwriters" within the meaning of Section 2(a)(11) of the Securities Act, as Rule 144A provides that reoffers and resales made in compliance with the rule are not "distributions." Resellers that are not issuers, underwriters or dealers may rely on the exemption provided by Section 4(a)(1) of the Securities Act while resellers that are dealers may rely on Section 4(a)(3) of the Securities Act.

Under Rule 144(a)(3) of the Securities Act, securities acquired in a Rule 144A transaction are "restricted securities." Unless the securities are subsequently registered (for example, if a registration statement was filed pursuant to a registration rights agreement for the applicable securities), the securities will remain restricted for the duration of the applicable holding period. Resales of restricted securities may only be made in reliance on an applicable exemption under the Securities Act. In addition to Rule 144, exempt resales of restricted securities also may be made in compliance with Rule 144A, the Section 4(a)(1½) exemption, Section 4(a)(7) or Regulation S.

At the state level, Section 18 of the Securities Act exempts Rule 144A transactions from state regulation if (i) the issuer of the securities being resold in the Rule 144A transaction has a class of securities listed and traded on the New York Stock Exchange (NYSE), NYSE American or the Nasdaq Market System and (ii) the securities being resold in the Rule 144A transaction are equal or senior to the issuer's listed securities. For Rule 144A offerings of issuers without securities that are so listed, most state securities laws contain an exemption from registration for reoffers and resales made to QIBs within the meaning of Rule 144A or an institutional investor exemption broad enough to encompass QIBs.

Rule 144A offerings are also exempt from filing under FINRA's Corporate Financing Rule and FINRA's requirement to file private placement documents.

Financial institution and insurance company issuers often use Rule 144A continuous issuance programs for multiple offerings (usually of debt securities) to potential offerees. Rule 144A programs are generally similar to "medium-term note programs," but they are sold only to QIBs.

Eligible Purchasers

As a condition of Rule 144A, the resale may be made to a purchaser that the reseller (and any person acting on its behalf) reasonably believes is a QIB. A QIB is an institution (not a natural person), foreign or domestic, included within one of the categories of institutional "accredited investors" defined in Rule 501 of Regulation D, acting for its own account or the accounts of other QIBs that meets certain financial thresholds (outlined in greater detail below). A reasonable belief that the purchaser is a QIB may be established based on a QIB representation letter or based on recent financial information about the entity. Recent financial information may include publicly available annual financial statements, information filed with a governmental agency or self-regulatory organization, a certification by the entity's chief financial or other executive officer, or information in a recognized securities manual, in each case as of a date not more than 16 months for a domestic entity or 18 months for a foreign entity preceding the sale.

To be considered a QIB, an entity must also, in the aggregate, own and invest on a discretionary basis at least $100 million in securities ($10 million for a broker-dealer) of issuers not affiliated with the entity. QIBs that are banks and savings and loan associations must also have a net worth of at least $25 million. Entities formed solely for the purpose of acquiring restricted securities in a Rule 144A transaction will be QIBs, provided that they satisfy the QIB requirements.

To determine whether an entity owns and invests the requisite amount of securities, the value of the securities is typically calculated on a cost basis. However, an entity may use fair market value basis where it does so for financial reporting purposes and no current information with respect to the cost of such securities has been published. If an entity reports both cost and fair market values of the securities it holds, only the cost valuation method will be used to determine whether that entity is a QIB. The value of the securities to be purchased in the Rule 144A transaction may not be included in an entity's aggregate total, and bank deposit notes, certificates of deposit, loan participations, repurchase agreements, and currency, interest rate, and commodity swaps must also be excluded. Securities held by an entity's consolidated subsidiaries may be included if such securities are managed by that entity and either (i) the

entity is a reporting company under the Securities Exchange Act of 1934 (the "Exchange Act") or (ii) the entity itself is not a majority-owned subsidiary that would be included in the consolidated financial statements of another enterprise.

A broker-dealer acting as a riskless principal for a QIB will also be deemed to be a QIB. In a riskless principal transaction, the broker-dealer must have a commitment from its customer, the QIB, that it will simultaneously purchase the securities from the broker-dealer. This commitment must be in place at the time of purchase in the Rule 144A transaction.

In establishing a reasonable belief that a potential purchaser is a QIB, a seller has no obligation to confirm the validity of any information and may rely on available information that shows an entity is a QIB, even where more recent information is available (including where the more recent information indicates that a purchaser now holds fewer securities). However, a seller cannot rely on information or certifications that it knows, or is reckless in not knowing, are false.

Eligible Securities

The eligibility of the securities that can be offered in reliance on Rule 144A is determined at time of issuance. To rely on Rule 144A, the securities must not be fungible with a class of securities listed on a U.S. national securities exchange or quoted on a U.S. automated inter-dealer quotation system, and must not be securities of an open-end investment company, unit investment trust or face amount certificate company that is, or is required to be, registered under the Investment Company Act of 1940. Because eligibility for Rule 144A purposes is determined at the time of issuance, securities of the same class that are thereafter listed will not affect Rule 144A eligibility.

Whether a security is deemed to be fungible with or of the same class as listed securities depends on the type of security:

- Common stock, preferred stock and debt securities are deemed to be of the same class if the material terms and the rights and the privileges of the holders of the class of securities are substantially the same as those of the listed securities. American Depositary Receipts (ADRs) are of the same class as the underlying securities.
- Warrants with a term less than three years or an effective exercise premium at pricing of the Rule 144A offering of less than 10% will be treated as the same class as the underlying security. The exercise premium is calculated by: (i) taking its price at issuance; (ii) adding to such price its aggregate exercise price; (iii) subtracting from such number the aggregate market value (as of the pricing day of the warrants) of the securities that would be received on exercise; and (iv) dividing the difference by the amount subtracted in (iii).
- Convertible or exchangeable securities with an effective conversion premium at pricing of the Rule 144A offering of less than 10% are considered to be of the same class as the underlying security. The effective conversion premium is calculated by: (i) taking its price at issuance; (ii) subtracting from such price the aggregate market value (as of the pricing day of the convertible securities) of the securities that would be received on conversion; and (iii) dividing the difference by the amount subtracted in (ii).

As described above, securities acquired in a Rule 144A resale are deemed to be "restricted securities" within the meaning of Rule 144(a)(3) of the Securities Act (*i.e.*, they are not freely tradeable absent an exemption or registration of the resale under the Securities Act until the end of the applicable holding period under Rule 144). A six-month holding period is required for restricted securities of an issuer that has been a reporting company under the Exchange Act for at least 90 days and is current in those reporting obligations at the time of sale. A one-year holding period is required for restricted securities of a non-reporting company or a reporting company that is not current in its reporting obligations at the time of sale. As a result of the limitations on resale and the related reduction in liquidity, the seller must make the purchaser aware that the securities are being sold pursuant to Rule 144A. Typically this is achieved by placing a legend on the security itself and including appropriate notice in the offering documentation. The securities will also be assigned a restricted CUSIP number.

Conducting Traditional Rule 144A Transactions

RULE 144A OFFERING PROCESS

The Rule 144A offering process is often similar to the public offering process. Typically, a "red herring," or preliminary offering memorandum, is distributed to investors for the purpose of soliciting orders. Once the offering prices, a final term sheet is delivered to investors to indicate the final pricing terms and confirm orders. The comfort letter from the issuer's auditors will also be delivered to the initial purchasers at pricing. The closing usually takes place three to five days after pricing. The legal opinions and other closing documents will be delivered at closing.

RULE 144A OFFERING DOCUMENTATION

Unlike SEC-registered offerings, there are no specific SEC disclosure requirements for Rule 144A offerings. However, to avoid potential liability to the initial purchasers, Rule 144A offering documents are quite similar to the prospectuses prepared for SEC-registered offerings in terms of the scope and depth of disclosure. The documentation used in a Rule 144A transactions is also similar to that used in registered offerings and includes:

- An offering memorandum, which typically contains a detailed description of the issuer, including its business and financial results, and the details of the securities to be offered, as well as risk factors, a discussion of the issuer's management, tax considerations and other matters. If the issuer is an Exchange Act reporting company, the offering memorandum will incorporate by reference the issuer's Exchange Act filings, making the document significantly shorter. The offering memorandum will also include an appropriate notice to the investors regarding the restricted nature of the 144A securities and a section detailing transfer restrictions.

- A purchase agreement between the issuer and the initial purchasers that provides that the initial purchasers (equivalent to underwriters in a registered offering) may directly or through U.S. broker-dealer affiliates arrange for the offer and resale of securities within the United States only to QIBs pursuant to Rule 144A. The form, organization and content of the purchase agreement often resemble an underwriting agreement for a public offering in many respects but is modified to reflect the manner of offering.

- In some cases, a registration rights agreement between the issuer and the initial purchasers will also be executed by the parties. Occasionally, purchasers may require registration rights. The two principal methods to register Rule 144A securities under the Securities Act are Exxon Capital exchange offers and resale shelf registrations under Rule 415 of the Securities Act. Because of certain administrative issues, Exxon Capital exchange offers are the preferred means for providing holders of Rule 144A securities with freely tradable securities.

- Closing documents, including legal opinions, comfort letters, officer's and secretary's certificates, and other customary deliverables will also accompany an offering.

INFORMATION REQUIRED TO BE DELIVERED FOR NON-REPORTING ISSUERS

Specific information is required to be delivered to the purchasers under Rule 144A if the issuer is <u>not</u> a reporting company under the Exchange Act, a foreign company exempt from reporting under Rule 12g3-2(b) or a foreign government. In those cases, the holder of the securities and any prospective purchaser designated by the holder must have the right to obtain from the issuer, upon request, a brief description of the issuer's business, products and services and the issuer's most recent audited financial statements. The information provided must be "reasonably current" in relation to the date of resale under Rule 144A, generally as of a date within 12 months prior to the resale for U.S. issuers and within the timing requirements imposed by the jurisdiction of a non-U.S. issuer. This right to information, required under Rule 144A, is agreed to by the issuer with the initial purchasers in the purchase agreement.

RULE 144A OFFERING LIABILITY AND DUE DILIGENCE INVESTIGATION

Although initial purchasers and issuers in a Rule 144A offering are not subject to liability under Section 11 of the Securities Act, they could be subject to liability for material misstatements and omissions under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As a result of potential liability under Section 10(b) and Rule 10b-5, an offering memorandum for a Rule 144A offering usually contains information comparable to what a prospectus for a registered offering would contain.

The "due diligence" defense for underwriters that may be established under Section 11 of the Securities Act (but not issuers, who are strictly liable) is only applicable to registered offerings, not Rule 144A offerings. Nonetheless, a due diligence investigation will result in better and more thorough disclosure and also enables the initial purchaser to evaluate the relevant risks and to decide whether to undertake an offering.

As with a registered offering, the Rule 144A due diligence process consists of business and management due diligence and documentary (or legal) due diligence. The initial purchasers in a Rule 144A offering and their counsel will conduct a review of the issuer's public filings and other publicly available information; verify company information through independent sources; undertake a close review of the issuer's financial statements, corporate documents and key contracts; conduct interviews with management, key employees and site visits; and obtain appropriate legal opinions and comfort letters.

RULE 159 UNDER THE SECURITIES ACT

Rule 159 provides that the adequacy of the disclosure in a prospectus is evaluated as of the time that an investor forms a contract to purchase the securities and that no information provided after that time may be considered for purposes of liability determinations with respect any misstatements or omissions in the offering materials.

As a general practice, the purchase contract is usually delivered before the final prospectus. To meet the Rule 159 standard, in registered offerings, especially in debt offerings, the issuer or the underwriters usually provide investors with a final term sheet or similar document with the information that was not included in the preliminary prospectus, such as pricing-specific information or corrections to the preliminary prospectus at the time of pricing. Although Rule 159 only applies to registered public offerings, Rule 144A offerings tend to adopt this practice, including the delivery of term sheets and required statements in legal opinions and officer certificates, based on concerns that a court could apply a similar standard in evaluating the sufficiency of disclosure in a Rule 144A offering.

Concurrent Regulation S Offering

Regulation S under the Securities Act provides another exemption from the registration requirements of the Securities Act. Regulation S applies to securities offered and sold outside the U.S. to non-U.S. persons. It is very common to have a Rule 144A tranche offered to QIBs and a Regulation S tranche offered to non-U.S. purchasers. In order to ensure lawful transfer in the secondary market, these tranches are usually represented by separate global certificates because Regulation S debt securities usually have a restricted holding period that is shorter than the Rule 144 holding period. In such a case, the Rule 144A global certificate with a Rule 144A restrictive legend is deposited with The Depository Trust Company (DTC), while the Regulation S global certificate with a Regulation S restrictive legend is deposited with a European clearing system. The Rule 144A securities can be re-sold to non-U.S. purchasers that are not QIBs if the sale complies with Regulation S. Similarly, the Regulation S securities can be re-sold in the U.S. to QIBs if the resale complies with Rule 144A. The registrar of the securities will track increases or decreases in the respective certificates.

Subsequent Registration

Securities sold pursuant to Rule 144A may be subsequently registered under the Securities Act pursuant to a registration rights agreement (as described above); however, it is also possible for an issuer to become obligated to register equity securities sold pursuant to Rule 144A even where a registration rights agreement was not executed in connection with the transaction.

Rule 144A Offering Market and Recent Trends

Rule 144A now permits general solicitation and general advertising, provided that actual sales are only made to persons that are reasonably believed to be QIBs. Consequently, prior practices for Rule 144A offerings, such as internet roadshows available to QIBs only and using password protection, are no longer technically required, although initial purchasers continue to limit the use of general solicitation. For Regulation S offerings with a Rule 144A tranche, general solicitation and general advertising in connection with the Rule 144A tranche will not be viewed by the SEC as "directed selling efforts" in connection with the concurrent Regulation S offering.

Checklist of Key Questions

- ✓ Is the security eligible for Rule 144A?
- ✓ Are the purchasers QIBs?
- ✓ Will the Rule 144A offering be made concurrent with a Regulation S offering?
- ✓ Is the issuer an Exchange Act reporting company? If not, will the issuer be able to provide the required information to investors following the offering?
- ✓ What type of offering is contemplated – is it a Rule 144A for life offering? A traditional Rule 144A offering?
- ✓ Will the issuer commit to provide registration rights?
- ✓ Has diligence satisfactory to the initial purchasers been conducted?
- ✓ Will the issuer offer securities contemporaneously in a private placement?

Here's the Deal:

- Regulation S provides an exclusion from the Section 5 registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), for offerings made outside the United States by both U.S. and foreign issuers.
- Regulation S is available only for "offers and sales of securities outside the United States" made in good faith and not as a means of circumventing the Securities Act registration requirements.
- The availability of the Regulation S issuer and resale safe harbors are contingent on two general conditions:
    - the offer or sale must be made in an offshore transaction; and
    - no "directed selling efforts" may be made by the issuer, a distributor, any of their respective affiliates or any person acting on their behalf.
- The Regulation S safe harbors are non-exclusive, meaning that an issuer may also rely on another applicable exemption from registration.

What's the Deal?

Regulation S provides an exclusion from the Section 5 registration requirements of the Securities Act for offers made outside the United States by both U.S. and foreign issuers to non-U.S. persons. A securities offering, whether private or public, made by an issuer outside of the United States in reliance on Regulation S is not required to be registered under the Securities Act. Regulation S provides safe harbors that are non-exclusive; as a result, an issuer that relies on Regulation S also may claim the availability of another applicable exemption from registration. Regulation S is available for offerings of both equity and debt securities.

Regulation S is available only for "offers and sales of securities outside the United States" made in good faith and not as a means of circumventing the Securities Act registration requirements. The availability of the issuer (Rule 903) and the resale (Rule 904) safe harbors is contingent on two general conditions:

- The offer or sale must be made in an offshore transaction; and
- No "directed selling efforts" may be made by the issuer, a distributor, any of their respective affiliates or any person acting on their behalf.

ENTITIES THAT MAY RELY ON REGULATION S

The following entities may rely on Regulation S:

- U.S. issuers – both reporting and non-reporting issuers may rely on the Rule 901 general statement or the Rule 903 issuer safe harbor;
- Foreign issuers – both reporting and non-reporting foreign issuers may rely on the Rule 901 general statement or the Rule 903 issuer safe harbor;
- Distributors (underwriters and broker-dealers) – both U.S. and foreign financial intermediaries may rely on the Rule 901 general statement or the Rule 903 issuer safe harbor;
- Affiliates of the issuer – both U.S. and foreign;
- Any persons acting on the behalf of the aforementioned persons;
- Non-U.S. resident purchasers (including dealers) who are not offering participants may rely on the Rule 901 general statement or the Rule 904 resale safe harbor to transfer securities purchased in a Regulation S offering; and
- U.S. residents (including dealers) who are not offering participants may rely on the Rule 901 general statement or the Rule 904 resale safe harbors in connection with purchases of securities on the trading floor of an established foreign securities exchange that is located outside the United States or through the facilities of a designated offshore securities market.

TYPES OF ISSUERS WHO MAY NOT RELY ON REGULATION S

Regulation S is not available for the offer and sale of securities issued by open-end investment companies, unit investment trusts registered or required to be registered under the Investment Company Act of 1940 (the "1940 Act") or closed-end investment companies required to be registered, but not registered, under the 1940 Act.

Requirements that Must Be Met in Order to Rely on Regulation S

Market participants may rely on the issuer and resale safe harbors of Regulation S only if (1) the offer or sale is made as part of an "offshore transaction" and (2) none of the parties make any "directed selling efforts" in the United States. The "parties" in an initial issuance, under Rule 903, would be the issuer, a distributor, any of their respective affiliates or any person acting on behalf of any of the foregoing. In a resale transaction under Rule 904, the "parties" would be any person other than the issuer, a distributor, any of their respective affiliates (except any officer or director who is an affiliate solely by virtue of holding such position) and any person acting on behalf of any of the foregoing. In addition, offerings made in reliance on Rule 903 are subject to additional restrictions that are connected with the level of risk that securities in a particular type of transaction will flow back into the United States.

Rule 903 prescribes three categories of transactions (summarized below) based on the type of securities being offered and sold, whether the issuer is domestic or foreign, whether the issuer is a reporting issuer under the Exchange Act and whether there is a "substantial U.S. market interest," or "SUSMI."

"Category 1" transactions are those in which the securities are least likely to flow back into the United States. Therefore, the only restrictions are that the transaction must be an "offshore transaction" and that there be no "directed selling efforts" in the United States.

"Category 2" and "Category 3" transactions are subject to an increasing number of offering and transactional restrictions for the duration of the applicable "distribution compliance period." A "distribution compliance period" is the period following the offering when any offers or sales of Category 2 or 3 securities must be made in compliance with the requirements of Regulation S in order to prevent the flow back of the offered securities into the United States. The period ranges from 40 days to six months for reporting issuers or one year for equity securities of non-reporting issuers.

Types of Transactions that May be Conducted Under Regulation S

There are several types of Regulation S offerings that U.S. or foreign issuers may conduct:

- A standalone Regulation S offering, in which the issuer conducts an offering of debt or equity securities solely in one or more non-U.S. countries;
- A combined Regulation S offering outside the United States and Rule 144A offering inside the United States; and
- Regulation S continuous offering programs for debt securities, including various types of medium-term note programs (these continuous offering programs may be combined with an issuance of securities to qualified institutional buyers (QIBs) in the United States under Rule 144A).

Regulation S also permits two other types of offerings: (1) offerings made under specified conditions pursuant to an employee benefit plan established and administered in accordance with the law of a country other than the United States and in accordance with that country's practices and documentation; and (2) offerings of foreign government securities.

The Regulation S tranche of any offering refers only to the part of the offering in which the offering participants must comply with Regulation S in order to benefit from the safe harbor. The offering itself also must comply with the requirements of the applicable non-U.S. jurisdictions and the requirements of any foreign securities exchange or other listing authority. A Regulation S-compliant offering could be combined with a registered public offering in the United States or an offering exempt from registration in the U.S., as well as be structured as a public or private offering in one or more non-U.S. jurisdictions.

CONCURRENT EXEMPT OR EXCLUDED OFFERINGS WITH REGULATION S TRANSACTIONS

A contemporaneous registered offering or exempt private placement in the United States will not be integrated with an offshore offering that otherwise complies with Regulation S for the purpose of determining whether Rule 903's general requirement is met. In fact, Regulation S contemplates that a private placement in the United States may be made simultaneously with an offshore public offering in reliance on the issuer safe harbor. Offshore offerings and sales of securities made in reliance on Regulation S do not preclude the resale of those same securities made in reliance on Rule 144A or Regulation D, even if the resale occurs during the distribution compliance period. Conversely, in determining whether the requirements for a Section 4(a)(2) exempt private placement are met, offshore transactions made in compliance with Regulation S will not be integrated with domestic offerings that are otherwise exempt from registration under the Securities Act.

Distribution Compliance Periods Applicable to the Sale of Regulation S Securities

Securities cannot be offered or sold to a U.S. person during the distribution compliance period unless the transaction is registered under the Securities Act or exempt from registration. There is no distribution compliance period in connection with securities sold in a Category 1 transaction.

The distribution compliance period for Category 2 transactions involving both equity and debt securities and for Category 3 transactions involving debt securities is 40 days. The distribution compliance period for Category 3 offerings of equity securities is six months, if the issuer is a reporting company, and one year otherwise.

The distribution compliance period normally begins on the later of:

- The date on which the securities were first offered to persons other than distributors in reliance upon Regulation S; or
- The date of closing of the offering.

All offers and sales by a distributor of an unsold allotment are considered to be made during the distribution compliance period.

MEASUREMENT OF THE DISTRIBUTION COMPLIANCE PERIOD BY THE TYPE OF SECURITY

Distribution compliance periods for continuous offerings of medium-term notes, warrants, convertible securities and American depositary receipts (ADRs) are measured differently:

<u>Medium-Term Notes</u>

The distribution compliance period for a continuous offering begins at the completion of the distribution, as determined and certified by the managing underwriter or person performing similar functions. For continuous offering programs, such as medium-term note programs, the distribution compliance period is determined on a tranche-by-tranche basis. As to any tranche, the distribution compliance period begins when the manager for the offering certifies the completion of the distribution of that tranche.

<u>Warrants</u>

Securities underlying warrants are considered to be subject to a continuous distribution as long as the warrants remain outstanding, provided that the legending and certification requirements of Rule 903(b)(5), which are designed to limit the exercise of warrants by U.S. persons, are satisfied. The distribution compliance period will commence upon completion of the distribution of the warrants, as determined and certified by the managing underwriter or person performing similar functions.

<u>Convertible Securities</u>

For convertible securities, both the convertible security and the underlying security are treated in the same manner. The distribution compliance period for both the convertible and the underlying security typically commences on the later of: (1) the date on which the offering of the convertible security closes or (2) the date on which the convertible security was first offered to persons other than distributors in

reliance on Regulation S. If, however, conversion of the convertible security is not exempt under section 3(a)(9) of the Securities Act, the convertible security will be treated in the same manner as a warrant.

<u>ADRs</u>

U.S. depositary banks issue ADRs and each represents one or more shares, or a fraction of a share, of a foreign issuer. ADRs allow foreign equity securities to be traded on U.S. stock exchanges. By owning an ADR, an investor has the right to obtain the foreign share that the ADR represents, although most U.S. investors find it is easier to own just the ADR. An American Depositary Share (ADS), on the other hand, is the actual underlying foreign share that an ADR represents. The issuance of ADRs in exchange for the underlying foreign shares or the withdrawal of deposited ADRs during the distribution compliance period is not precluded by Regulation S.

Eligible Transactions: What is an "Offshore Transaction"?

An offer or sale of securities is made in an "offshore transaction" if (i) the offer is not made to a person in the United States (other than a distributor); and (ii) either (1) at the time the buy order is originated, the buyer is physically located outside the United States or the seller and any person acting on his behalf has a reasonable belief that the buyer is outside the United States or (2) the transaction is for purposes of Rule 903, executed on a physical trading floor of an established foreign securities exchange or, for purposes of Rule 904, executed on a "designated offshore securities market" and the seller is not aware that the transaction has been pre-arranged with a U.S. purchaser.

An offering participant may establish a "reasonable belief" that the buyer is outside the United States based on any number of approaches. For purposes of the Rule 903 issuer safe harbor, it is sufficient if the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange. For purposes of the Rule 904 resale safe harbor, it is sufficient if the transaction is executed in, on or through the facilities of a "designated offshore securities market" and neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States.

Notwithstanding these provisions, offers and sales of securities specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces serving overseas, are not deemed to be made in offshore transactions. Conversely, offers and sales to persons excluded from the definition of "U.S. person" because they are international organizations (*e.g.,* the United Nations) or their affiliates, or with persons holding accounts excluded from the definition of U.S. person because they manage those accounts on behalf of non-U.S. persons, are deemed to be made in "offshore transactions."

Eligible Transactions: What are "Directed Selling Efforts"?

"Directed selling efforts" is defined as "any activity undertaken for the purpose of, or that could be reasonably expected to result in, conditioning the U.S. market for the relevant securities." This applies during the offering period as well as during any distribution compliance period. Selling efforts could still be initiated from the United States, provided that these efforts are directed or effected abroad.

The following activities constitute "directed selling efforts" targeted at U.S. persons:

- Advertising the offering in publications with a "general circulation" in the United States (which includes any publication printed primarily for distribution in the United States or that has had on average a circulation of at least 15,000 copies per issue within the prior twelve months);
- Mailing printed materials to U.S. investors;
- Conducting promotional seminars in the United States;
- Placing advertisements with radio or television stations that broadcast in the United States; and
- Making offers directed at identifiable groups of U.S. citizens in a foreign country, such as members of the U.S. military.

Certain communications and advertisements are excluded from the definition of "directed selling efforts," including:

- Any advertisement required to be published by U.S. or foreign laws, regulatory or self-regulatory authorities, such as a stock exchange, where the advertisement contains no more information than that legally required and includes a restrictive legend stating that the securities have not been registered under the Securities Act and sales in the United States and to U.S. persons are restricted;
- A communication with persons, including U.S. managers or investment advisers, who are acting on behalf of an account which is a non-U.S. person (defined in Rule 902(k) as persons excluded from the definition of U.S. person);
- A tombstone advertisement in a publication having less than 20% of its worldwide circulation in the United States that contains the applicable restrictive legend and limited information about the issuer, managing underwriters, sales commencement and conclusion dates and both qualitative and quantitative details about the securities being sold;
- Bona fide visits and tours of real estate facilities in the United States by prospective investors;
- Quotations of a foreign broker-dealer distributed by a third-party system that primarily distributes this information in foreign countries, provided that no security transaction can be executed through the system between broker-dealers and persons in the United States, and no communication with U.S. persons is initiated;
- A notice in accordance with Rule 135 or Rule 135c of the Securities Act that an issuer intends to make a registered or unregistered offering of its securities;
- Providing journalists with access to issuer meetings held outside the United States or providing written press or press-related materials released outside the United States in compliance with Rule 135e of the Securities Act;
- Isolated limited contact within the United States (*i.e.,* minor, inadvertent contact within the United States);
- Routine activities conducted in the United States unrelated to selling efforts, including normal communications to shareholders; and

- Publication and distribution of research reports by a broker or dealer under Rule 138(c) or Rule 139(b) of the Securities Act.

RULE 135c-COMPLIANT PRESS RELEASES AND REGULATION S OFFERINGS

It is permissible for issuers to use a Rule 135c-compliant press release to announce a Regulation S offering. Under Rule 135c of the Securities Act, an announcement that an issuer proposes to make, is making or has made an unregistered offering will not be deemed to be an offer of securities, for purposes of Section 5 of the Securities Act, if, among other things, the announcement contains certain limited information regarding the offering (*e.g.,* the name of the issuer, the basic terms and size of the offering, the timing of the offering, a brief statement of the manner and purpose of the offering and statements that the securities have not been registered) and is not used for the purpose of conditioning the market in the United States for the offered securities. A press release that complies with Rule 135c is not a "directed selling effort" and therefore will not affect the availability of the Regulation S safe harbor.

In addition, for Regulation S offerings with a Rule 144A tranche, the SEC has clarified that general solicitation and general advertising in connection with a Rule 144A offering will not be viewed as "directed selling efforts" in connection with a concurrent Regulation S offering. This is particularly relevant because general solicitation and general advertising are now permitted for Rule 144A offerings (so long as the securities are sold to a QIB or to a purchaser that the seller and any person acting on the seller's behalf reasonably believes is a QIB). Therefore, issuers may broadly disseminate a press release regarding a proposed or completed Rule 144A offering without the prior restrictions on the types of permitted information under Rule 135c.

Offering participants should be mindful that Rule 135c is a non-exclusive safe harbor, and offering-related press releases may comply with a different safe harbor, such as Rule 135e under the Securities Act in respect of any offshore activities for any Regulation S tranche. Under Rule 135e, foreign issuers, selling securityholders or their representatives will not be deemed to offer any security for sale, for purposes of Section 5 of the Securities Act, by virtue of providing any journalist with access to any of the following:

- Its press conferences held outside of the United States;
- Meetings with the issuer or selling securityholder representatives conducted outside of the United States; or
- Written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, if:
    - The present or proposed offering is not being, or to be, conducted solely in the United States;
    - Access is provided to both U.S. and foreign journalists; and
    - Any written press-related materials pertaining to transactions in which any of the securities will be or are being offered in the United States satisfy the requirements of Rule 135e(b) with respect to legends and certain other information.

What is a "U.S. Person"?

A U.S. person includes:

- Any natural person resident in the United States;
- Any partnership or corporation organized or incorporated under the laws of the United States;
- Any estate of which any executor or administrator is a U.S. person;
- Any trust of which any trustee is a U.S. person;
- Any agency or branch of a U.S. person located outside the United States;
- Any non-discretionary or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person;
- Any discretionary or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or, if an individual, resident in the United States
- Any partnership or corporation if (1) organized or incorporated under the laws of any foreign jurisdiction and (2) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated and owned by accredited investors under Rule 501(a) of the Securities Act who are not natural persons, estates or trusts.

The following are explicitly excluded from the definition of "U.S. person":

- Any discretionary or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated or, if an individual, resident in the United States;
- Any estate of which any professional fiduciary acting as executor or administrator is a U.S. person, if (1) an executor or administrator who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate and (2) the estate is governed by foreign law;
- Any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settler if the trust is revocable) is a U.S. person;
- An employee benefit plan established and administered in accordance with the laws, customary practices and documentation of a country other than the United States;
- Any agency or branch of a U.S. person located outside the United States if (1) the agency or branch operates for valid business reasons and (2) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation in the jurisdiction where it is located; and
- Such international organizations (and their agencies, affiliates and pension plans) as the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the United Nations.

Information Requirements Under Regulation S

Reasonable steps that a reseller must take to make the buyer aware that the reseller may rely on Regulation S in connection with the resale.

OFFERING MEMORANDUM

If the offering is a standalone Regulation S offering (or a Regulation S tranche of a combined Rule 144A/Regulation S offering) and the securities are either Category 2 or Category 3, the offering memorandum and any other offering materials and documents (other than press releases) used in connection with offers and sales prior to the expiration of the applicable distribution compliance period must include:

- Statements to the effect that the securities have not been registered under the Securities Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the Securities Act, or an exemption from such registration requirements is available; and
- For equity securities of domestic issuers, an additional statement that hedging transactions involving those securities may not be conducted unless in compliance with the Securities Act.

In addition, for Category 3 equity securities:

- The offer or sale, if made prior to the expiration of the one-year distribution compliance period (six months for a reporting issuer), may not be made to a U.S. person or for the account or benefit of a U.S. person (other than a distributor); and
- The offer or sale, if made prior to the expiration of the applicable one-year or six-month distribution compliance period, is made pursuant to the following conditions:
    - The purchaser (other than a distributor) certifies that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or is a U.S. person who purchased securities in a transaction that did not require registration under the Securities Act; and
    - The purchaser agrees to resell such securities only in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration, and agrees not to engage in hedging transactions with regard to such securities unless in compliance with the Securities Act.

The purchaser's certifications are described in the offering memorandum and in most cases, a purchaser is deemed to have made such representations when it purchases beneficial interests in the Regulation S global security.

The offering memorandum for a combined Rule 144A/Regulation S offering usually contains extensive disclosure regarding resale limitations and transfer restrictions. If the securities will be held in book-entry format, as is customary, the disclosure also will include information regarding:

- The book-entry process and the forms of global securities;
- The delivery of the securities;

- The depositary procedures of The Depository Trust Company, Euroclear and Clearstream as holders of the book-entry certificates, particularly with respect to payments and any voting rights relating to the securities;
- The exchange of global notes for certificated notes, which is required under specified circumstances, and generally the prohibition on the exchange of certificated notes for beneficial interests in the global notes;
- Exchanges between the Rule 144A security and any Regulation S security;
- Same-day settlement and payment procedures; and
- Any registration rights, including discussion of any registered exchange offer.

LEGEND

Pursuant to the requirements of Regulation S, the certificates for a domestic issuer's securities must contain a legend to the effect that transfer is prohibited except in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration, and that hedging transactions involving those securities may not be conducted unless in compliance with the Securities Act.

Regulation S requires such issuers, either by contract or a provision in its bylaws, articles, charter or comparable document, to refuse to register any transfer of the securities not made in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration. However, the SEC recognized that securities of foreign issuers are often issued in bearer form and that foreign law may prevent the issuer for refusing to register securities transfers. Therefore, in such cases, it is permissible under Regulation S for an issuer to implement "other reasonable procedures" to prevent any transfer of the securities not made in accordance with the provisions of Regulation S.

CONFIRMATION

Furthermore, Regulation S requires each distributor selling securities to a distributor, a dealer or a person receiving a selling concession, fee or other remuneration, prior to the expiration of a 40-day distribution compliance period in the case of debt securities, or the applicable one-year or six-month distribution compliance period in the case of equity securities, to send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.

Conducting a Regulation S Transaction: Overview of the Three Categories of Transactions Under Regulation S

CATEGORY 1 TRANSACTIONS

Category 1 transactions include offerings of:

- Securities by foreign issuers who reasonably believe at the commencement of the offering that there is no SUSMI in certain securities;
- Securities by either a "foreign issuer" or, in the case of non-convertible debt securities, a U.S. issuer, in an "overseas directed offering";

- Securities backed by the full faith and credit of a foreign government; and
- Securities by foreign issuers pursuant to an employee benefit plan established under foreign law.

CATEGORY 2 TRANSACTIONS

Category 2 transactions include offerings of:

- Equity securities of a reporting foreign issuer;
- Debt securities of a reporting U.S. or foreign issuer; and
- Debt securities of a non-reporting foreign issuer.

CATEGORY 3 TRANSACTIONS

Category 3 is the residual safe harbor because it applies to all transactions not eligible for the Category 1 or Category 2 safe harbors. Category 3 transactions include:

- Debt or equity offerings by non-reporting U.S. issuers;
- Equity offerings by U.S. reporting issuers; and
- Equity offerings by non-reporting foreign issuers for which there is a substantial U.S. market interest.

The Structure of a Regulation S Transaction

DEBT SECURITIES

<u>Category 1 Safe Harbor</u>

This issuer safe harbor is available for debt offerings if a foreign issuer reasonably believes at the commencement of the offering that there is no SUSMI in the debt securities. A SUSMI in debt securities exists if:

- The issuer's debt securities are held of record by 300 or more U.S. persons, and
- U.S. persons hold of record at least 20% and at least $1 billion or more of the principal amount of debt securities, plus the greater of the liquidation preference or par value of non-participating preferred stock and the principal amount or balance of asset-backed securities.

If there is no SUSMI in a foreign issuer's debt securities, the issuer is only required to comply with the general Regulation S requirements. For Category 1 transactions, there is no distribution compliance period during which time the securities may not be resold. However, issuers engaging in a Category 1 transaction that includes a Rule 144A tranche may choose to impose a 40-day distribution compliance period.

Alternatively, foreign issuers of debt securities (and U.S. issuers of non-convertible debt securities) may rely on the Category 1 safe harbor if the transaction qualifies as an overseas directed offering. An offering of non-convertible debt securities of a U.S. issuer must similarly be directed into a foreign country in accordance with that country's local laws and customary practices, and the securities must be non-U.S. dollar-denominated or linked securities in order to qualify as an overseas directed offering. In addition, foreign issuers offering debt securities backed by the full faith and credit of a foreign government or that are offered pursuant to an employee benefit plan may rely on the Category 1 safe harbor, provided that the offers and sales are made as part of an offshore transaction and no directed selling efforts are made.

Category 2 Safe Harbor

This issuer safe harbor is available to both reporting and non-reporting non-U.S. issuers and reporting U.S. issuers of debt securities, subject to compliance with the offering and transactional restrictions for the applicable distribution compliance period. All Category 2 securities are subject to a 40-day distribution compliance period.

The issuer (as well as its affiliates and any distribution participants) must adhere to the following offering restrictions:

- Each distributor must agree in writing to the following:
    - All offers and sales of the securities prior to the expiration of a forty-day distribution compliance period must be made in accordance with Rule 903, pursuant to registration under the Securities Act or to an exemption from registration; and
    - For any offers and sales of equity securities of U.S. issuers, not to engage in hedging transactions with respect to such securities prior to the expiration of the distribution compliance period, unless in compliance with the Securities Act;
- All offering materials and documents (except press releases) used in connection with offers and sales of the securities prior to the expiration of the distribution compliance period must include legends in specified places in the prospectus or offering circular and in advertisements disclosing that the securities have not been registered under the Securities Act and may not be offered or sold in the United States or to U.S. persons (except distributors) absent registration under the Securities Act or in reliance on an exemption from registration; and
- The offering materials and documents relating to equity securities of U.S. issuers must state that hedging transactions involving such securities may not be conducted unless in compliance with the Securities Act.

An issuer must also comply with the following transactional restrictions:

- No offer or sale is made during the distribution compliance period to (or for the account or benefit of) a U.S. person, except for distributors; and
- Each distributor selling securities to a distributor, a dealer or a person receiving a selling concession, fee or other remuneration with respect to the securities sold, prior to the expiration of the distribution compliance period, sends a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales.

Non-compliance with the offering restrictions renders the safe harbor unavailable to all distribution participants. By contrast, noncompliance with the transactional restrictions renders the safe harbor unavailable only for the party (and its affiliates and persons acting on their behalf) that failed to comply with the restrictions.

Category 3 Safe Harbor

This issuer safe harbor is available to non-reporting U.S. issuers of debt securities, provided that the debt securities are not offered or sold to (or for the benefit of) a U.S. person (other than a distributor) during the 40-day distribution compliance period, except pursuant to the registration requirements of the Securities Act or an exemption from registration. Issuers must comply with the offering and transactional restrictions applicable to Category 2 offerings and the following three additional transactional restrictions during the distribution compliance period:

- The securities may not be offered or sold to (or for the account or benefit of) a U.S. person other than a distributor;
- The securities must be represented by a temporary global security that cannot be exchanged for definitive securities (1) by distributors until the end of the distribution compliance period and (2) for persons other than distributors, until certification of beneficial ownership of the securities by non-U.S. persons (or by any U.S. person who purchased the securities in an exempt transaction); and
- Any distributor selling securities to another distributor or to a dealer or any person receiving a selling concession or similar compensation must send confirmation to the purchaser before the end of the distribution compliance period stating that the purchaser is subject to the same restrictions on offers and sales applicable to a distributor.

EQUITY SECURITIES

The provisions of the issuer safe harbor that are specific to offerings of equity securities are summarized below.

Category 1 Safe Harbor

The Category 1 safe harbor is available for equity offerings if a foreign issuer reasonably believes at the beginning of the offering that there is no SUSMI in the equity securities. A SUSMI in equity securities exists if, during the shorter of the issuer's prior fiscal year or the period since incorporation, either:

- The U.S. securities exchanges and inter-dealer quotation systems in the aggregate, constituted the single largest market for a class of the issuer's securities; or
- At least 20% of all trading in a class of the issuer's securities occurred on the facilities of U.S. securities exchanges and inter-dealer quotation systems and less than 55% of such trading occurred on the facilities of the securities markets of a single foreign country.

If there is no SUSMI in a foreign issuer's equity securities, the issuer need only comply with the general Regulation S requirements to make offers and sales.

Category 2 Safe Harbor

The Category 2 safe harbor is only available for equity offerings by a reporting foreign issuer. Even if there is a SUSMI in the securities, reporting foreign issuers who implement the Category 2 offering and transactional restrictions for the distribution compliance period may rely on the safe harbor.

Category 3 Safe Harbor

The Category 3 safe harbor is available to any issuer of equity securities who, for the duration of a distribution compliance period of one year (or six months, if the issuer is a reporting company), implements and complies with the Category 2 offering and transactional restrictions and the following additional restrictions:

- The purchaser of the securities (except a distributor) must either certify (1) that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or (2) that it is a U.S. person who purchased securities in a transaction under an applicable exemption from registration under the Securities Act;
- The purchaser of the securities must agree to resell the securities only in accordance with Regulation S, pursuant to the registration requirements of the Securities Act or in reliance on an exemption from registration;
- The purchaser of the securities must agree not to engage in hedging transactions unless in compliance with the Securities Act;
- The securities of a U.S. issuer must contain a legend stating that (1) the transfer of the securities is prohibited unless made in accordance with Regulation S, pursuant to the registration requirements of the Securities Act or in reliance on an exemption from registration and (2) hedging transactions involving those securities must be made only in compliance with the Securities Act;
- The issuer must be required by contract or by its charter, bylaws or similar document to refuse to register any transfer made in violation of Regulation S unless the securities are in bearer form or foreign law prevents the issuer from refusing to register transfers. In the latter two instances, the issuer must implement other reasonable procedures in order to prevent any transfer of securities not made in accordance with Regulation S. For example, an issuer may include a legend on the securities stating that transfers not made in accordance with Regulation S, the registration requirements of the Securities Act or in reliance on an exemption from registration, are prohibited; and
- Any distributor selling securities to another distributor or to a dealer or any person receiving a selling concession or similar compensation must send confirmation to the purchaser before the end of the distribution compliance period stating that the purchaser is subject to the same restrictions on offers and sales applicable to a distributor.

Documentation in a Regulation S Debt Offering

In most circumstances, Regulation S offerings are combined with Rule 144A offerings. The documentation typically used in both debt and equity Rule 144A transactions, with or without a Regulation S tranche, is similar to that used in registered offerings, including:

- An offering memorandum (similar to a prospectus), which must bear legends stating that the securities have not been registered under the Securities Act and may not be offered or sold in the United States or to a U.S. person, absent registration under the Securities Act or in reliance on an

exemption therefrom. Moreover, for equity securities offered by U.S. issuers, the legends must also state that hedging transactions may not be conducted except in compliance with the Securities Act. These legends must appear both on (or inside) the cover page and in the underwriting section of any offering memorandum used in connection with the offer or sale of securities (if the legend is on the front page of the offering memorandum, it may be printed in summary form). Furthermore, due to the complexity of clearance and settlement procedures in global offerings, an offering memorandum usually includes extensive clearance and settlement discussions.
- A purchase agreement between the issuer and the initial purchasers, which is similar to an underwriting agreement. This agreement will include standard representations and warranties related to the issuer, the securities offered, the business and other representations designed to supplement the due diligence initial purchasers' investigation. Furthermore, the agreement will include representations, warranties and covenants specific to the Rule 144A/Regulation S offering, including: (i) the issuer will not use "directed selling efforts" as defined under Regulation S, and, if the securities offered are Category 2 or 3 securities, it has implemented the required Regulation S offering restrictions, (ii) the issuer has not engaged in general solicitation or general advertising (unless the issuer chooses to use general solicitation or general advertising, which are now permitted for Rule 144A offerings so long as the securities are sold to a QIB or to a purchaser that the seller and any person acting on the seller's behalf reasonably believes is a QIB), (iii) the offered securities meet the eligibility requirements under Rule 144A, (iv) the issuer is not an open-end investment company, unit investment trust or face-amount certificate company, and (v) if the securities are debt securities or ADRs, the issuer will not resell any securities in which it or any of its affiliates has acquired a beneficial ownership interest. For further discussion on the purchase agreement, please see "Additional Purchase Agreement Information" below.
- An agreement among underwriters or syndication agreement.[1]
- In some cases, a registration rights agreement between the issuer and the initial purchasers.
- In a debt offering, an indenture.
- Comfort letters from the issuer's auditors.
- Closing documentation, including "bring down" comfort letters, legal opinions, a "10b-5" or "negative assurance" letter from legal counsel, and closing certificates.

Similar to a registered offering, the issuer will work with its counsel, an investment bank, investment bank's counsel and independent accountants to prepare the required documents.

For a Rule 144A offering combined with a Regulation S offering, the Regulation S offering may be conducted using documents that are based on the country-specific practices of the relevant non-U.S.

[1] Many broker-dealers are already party to a "master agreement among underwriters" that governs the relationship among syndicate members. Therefore, a deal-specific agreement among underwriters typically is not required. Combined offerings that are syndicated to a substantial number of non-U.S. broker-dealers may use a number of syndication agreements, including agreements among underwriters (on a per syndicate level), intersyndicate agreements and transaction-specific dealer agreements. The International Primary Market Association's Standard Form Agreement Among Managers is sometimes used in Regulation S debt offerings syndicated primarily to London-based broker-dealers.

jurisdiction or jurisdictions. However, the disclosure documents in such a circumstance generally will contain the same substantive information so that investors have the same "disclosure package."

Additional Purchase Agreement Information

If the offering includes common equity, either directly or upon conversion of preferred stock or debt securities or upon exercise of warrants, the initial purchaser may require the issuer and even its senior management or other shareholders to "lock up" their common stock.

The initial purchasers in a combined Rule 144A/Regulation S transaction will also make limited representations, warranties and covenants which is distinct from an underwriting agreement in a public offering. The initial purchasers, as "distributors" (within the meaning of Regulation S) will also represent, warrant and covenant that they will offer and sell securities throughout the applicable distribution compliance period exclusively in compliance with either Regulation S or any other available exemption from the Securities Act registration requirements or pursuant to a registration statement filed with the SEC. If the transaction is an equity offering by a U.S. issuer, the distributor also must agree not to engage in any hedging transactions involving Category 2 or Category 3 securities during the distribution compliance period, unless in compliance with the Securities Act.

If there is a standalone Regulation S offering (or the combined offering is structured to permit separate Rule 144A and Regulation S syndicates), the agreement between the financial intermediaries and the issuer may not resemble a U.S.-style purchase (or underwriting) agreement.

The Trust Indenture Act

An indenture for a Regulation S (and a side-by-side Rule 144A) offering is not required to be qualified under the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act") because Rule 144A and Regulation S debt offerings are exempt from the registration requirements of the Securities Act. However, these debt offerings, particularly of U.S. issuers contemplating a subsequent registered exchange offering for the Rule 144A tranche, should be issued under an indenture that meets the requirements of the Trust Indenture Act. When the exchange offer registration statement is subsequently filed, the indenture must then be qualified under the Trust Indenture Act. In the ordinary course, issuers and initial purchasers choose trustees that can comply with the requirements of the Trust Indenture Act, but such trustee qualification (on Form T-1) also is required when the registration statement is subsequently filed. Although it is standard to use an indenture, if the debt will not be registered subsequently with the SEC (which is typical in a standalone Regulation S offering), a fiscal and paying agency agreement would be sufficient since it covers substantially the same matters.

Regulation S and FINRA Filing Requirements

Regulation S securities are exempt from the FINRA filing requirements. Securities offered in side-by-side offerings will also generally be exempt from the FINRA filing requirements, based on another applicable exemption.

REGULATION S SECURITIES AND TRACE REPORTING

The Trade Reporting and Compliance Engine (TRACE) is the FINRA-developed vehicle that facilitates the mandatory reporting of transactions in eligible (generally fixed income) securities by FINRA members.

While all FINRA members are required to report transactions in TRACE-eligible securities, dealers that are not registered with FINRA do not have TRACE reporting obligations.

Securities sold in a Regulation S transaction are not subject to TRACE reporting. However, if securities originally sold in a Regulation S transaction are later resold pursuant to another exemption, the subsequent sale may be subject to TRACE reporting. Additionally, Rule 144A securities in a Rule 144A/Regulation S side-by-side offering will be subject to TRACE reporting.

Checklist of Key Questions

- ✓ Is the offering made outside of the United States?
- ✓ Is the offer and sale made in an offshore transaction and no directed selling efforts are made?
- ✓ Does the offering involve a security with a substantial U.S. market interest?
- ✓ What category of issuer is involved with the offering?
- ✓ What category of transaction is the offering?
- ✓ What type of security is being issued?
- ✓ Will the Regulation S offering be made concurrent with a Rule 144A offering?

Here's the Deal:

- A rights offering provides a company's stockholders an opportunity to subscribe for additional shares, based on the number of shares they own as of a set record date.
- Rights offerings typically remain open for a set period, which is usually a couple weeks.
- A rights offering does not require stockholder approval, provided that the rights offering is not a "standby" rights offering, wherein the standby purchaser receives special rights or preferences.
- A majority of rights offerings involve non-transferable rights, although an issuer can also elect to structure an offering to permit rights to be transferable.
- Trading of the transferable rights can take place either on the securities exchange where the issuer's common stock is listed or over the counter, if the common stock is not listed on a securities exchange.

What's the Deal?

A rights offering typically provides an issuer's existing shareholders the opportunity to purchase a *pro rata* portion of additional shares (also referred to as "subscription warrants") of the issuer's stock at a specific price per share (the "subscription price"), which may be set at a discount to the recent trading price of the issuer's stock.

In a rights offering, all shareholders are given the right to purchase shares based on the number of shares they own on a specified record date, so there is no dilutive effect to shareholders who exercise the rights issued to them. Because there is no dilutive effect, stock exchange rules generally do not require issuers to obtain shareholder approval for issuances that may involve 20% or more of the outstanding shares at a discount to current market value.

Typically, a rights offering will be open for a period of a couple weeks. There are no federal securities laws requiring the rights offering to be open for a specified period of time.

Types of Rights Offerings

STANDBY RIGHTS OFFERING

In a standby rights offering, a third party (usually an underwriting syndicate, an investment bank, an affiliate of the investment bank or an affiliate of the issuer that may not be a registered broker-dealer) agrees, prior to the commencement of the rights offering, to purchase any shares or rights that are not subscribed for in the rights offering. This arrangement is commonly known as a "standby commitment," and provides the issuer with some assurance that it will raise the necessary capital. If the rights offering is structured as a standby rights offering, the issuer will enter into an agreement with the party agreeing to provide the standby commitment. An issuer may also consider a standby rights offering if the issuer's stock price is volatile. This is because the offering period is usually at least 16 days but can extend up to 60 days. Most shareholders will wait until the end of the subscription period to decide whether to exercise their rights. If the shares are trading in the market for the same or less than the subscription price, then shareholders will not exercise their rights. The issuer has to consider where to set its subscription price to avoid this, while not selling the shares at too steep of a discount price. Entering into a standby commitment may help mitigate this issue.

- **Fees associated with a standby commitment** As compensation for shifting the risk from the issuer if there is an under-subscription, the standby commitment party is paid a flat standby fee, plus a per share amount for each unsubscribed share purchased by it after the subscription offer expires and for each share purchased by it on the exercise of rights purchased in the secondary market, if the rights are transferable.
- **Requirements for standby commitment parties** There is no broker-dealer licensing requirement for standby commitment parties, although most are investment banks or an underwriting syndicate formed by an investment bank. However, one or more substantial investors will sometimes agree to act as a standby commitment party.

DIRECT RIGHTS OFFERING

In a direct rights offering, there is no standby commitment party or standby purchaser. Instead, the issuer only sells the number of shares evidenced by the exercised rights. A direct rights offering is cheaper than a standby rights offering because there are no fees associated with providing the standby commitment. However, a poorly subscribed direct rights offering may leave an issuer under-capitalized.

Preparation and Considerations in Connection with a Rights Offering

A rights offering requires advance planning and preparation. The issuer must take a number of actions within a certain time frame, including, but not limited to, the following: providing information to shareholders; marketing the rights offering to shareholders; collecting exercise certificates and payment from shareholders; and filing documentation with the SEC and the applicable stock exchange.

More specifically, the issuer must determine if it has sufficient authorized and unissued shares to accommodate the number of shares that could be issued in connection with the rights offering. If not, the necessary corporate actions must be taken to authorize new shares. The issuer's board of directors will be required to: (1) authorize the rights offering; (2) set the record date to determine the shareholders of record entitled to participate in the rights offering; (3) set an offer date; and (4) set an expiration date for the offer period.

If other events or activities, which require a record date, are approaching, such as a record date for an annual shareholders meeting, or dividend distribution, the issuer must also ensure that there are no conflicting shareholders of record for two different events or activities occurring around the same time period. Once the record date is set for the rights offering, no other record date for any other purpose should be set by the issuer for at least 7 business days after the expiration of the offering period.

Additional Considerations for a Standby Rights Offering

If an issuer chooses to conduct a standby rights offering, it will have to consider who will act as the standby commitment party, often referred to as the "standby purchaser," and the amount of the commitment, which will be based on the issuer's financing needs. Additionally, in a standby rights offering, the issuer may want to put a cap on the number of shares that the standby commitment party may acquire in order to avoid an inadvertent change of control. Furthermore, in a standby offering that involves transferable rights, a market may develop for the rights that may create arbitrage opportunities (between the issuer's common stock and the rights) or price volatility in the issuer's common stock.

Participants in Rights Offerings

Unless the issuer is a large corporation or has a highly concentrated shareholder base, it will most likely seek assistance from third-party participants. Depending on the size of the issuer and the type of rights offering, the issuer may engage a dealer-manager, a subscription agent and/or an information agent. The issuer also may engage an investment bank (underwriter) to act as the standby purchaser. The role of each party is presented in some detail below:

The role of the deal-manager. Usually a dealer-manager is hired to market the rights offering and solicit the exercise of rights and participation in the over-subscription privilege, if any. In a non-transferable rights offering, issuers may opt to avoid marketing expenses and sales commissions by doing this themselves.

The role of the subscription agent. Usually, a subscription agent is hired to send a prospectus or prospectus supplement, as the case may be, and to collect all of the completed subscription certificates and related payments from the shareholders. This role may be filled by an issuer's transfer agent.

The role of an information agent. Usually, an information agent is hired to answer any shareholder questions and provide further information about the rights offering. If the issuer has an adequately staffed investor relations department, a third party may not be required for this task.

Rights Offerings for Business Development Companies

Business development companies (BDCs) are closed-end funds that are regulated by the Investment Company Act of 1940, as amended (the "1940 Act"). Under regulatory constraints imposed by the 1940 Act, BDCs cannot issue shares of its common stock and sell them at a price below its net asset value (NAV) without first obtaining shareholder approval. However, if a BDC hopes to sell shares below the NAV, without shareholder approval, the BDC may do so through a rights offerings to its existing shareholders.

A BDC will typically complete a rights offering in two phases: the primary subscription period and the oversubscription period. In the first phase, shareholders are given the exclusive opportunity to purchase additional shares from the BDC, on a pro-rata basis. In the second phase, shareholders that have fully participated in the primary subscription period will be permitted to purchase additional shares as part of the oversubscription period. Rights offerings for BDCs can be transferable or non-transferable. In the case that a BDC rights offerings is transferable, shareholders will be allowed to sell those rights in the open market. The SEC's position, has generally been, that for every three shares of common stock currently outstanding, no more than one additional share of common stock can be issued in a transferable rights offering, below the NAV. In non-transferable rights offerings, however, BDCs will not be subject to these restrictions, since the anti-dilution concern is diminished.

Regulatory Requirements for Rights Offerings

Because the rights are granted to existing shareholders for no consideration, the rights do not need to be registered with the SEC; however, the issuer must register the shares that will be allocated to the shareholders who elect to participate in the rights offering. In certain circumstances, rights may need to be registered. In a transferable rights offering, if a controlling shareholder chooses to trade rights rather than exercise them, the requisite number of rights would need to be registered and a statement would need to be included in the prospectus stating that the prospectus may be used to cover the sales of rights by such controlling shareholder. The issuer must file a registration statement on Form S-1 or Form S-3, if eligible or, if an issuer has an effective existing shelf registration statement, the issuer can review it to determine if it covers the offer of rights.

Regulation M covers market manipulation during rights offerings. Therefore, if a rights offering involves a distribution as defined in Rule 100, the applicable restricted period of Rules 101 and 102 applies to bids for or purchases of the security being distributed and any reference security. Transactions involving the rights themselves are not subject to Rule 101 or 102. However, Rule 104 applies to stabilization transactions in any security, including the rights.

Stock Exchange Requirements for Rights Offerings

The New York Stock Exchange (NYSE) and Nasdaq Stock Market ("Nasdaq") have similar requirements for rights offerings, although summarized briefly below, these requirements require a closer look:

- **NYSE Rule 703.03(B) Nasdaq Rules 5250(b)(l).** The NYSE requires all known terms and details of a proposed rights offering to be publicly released immediately after the issuer's board of directors has taken action. Nasdaq requires the issuer to promptly disclose any material information that would reasonably be expected to affect the value of its securities.
- **NYSE Rule 703.03(B) Nasdaq Rules 5250 (e)(6).** The exchanges require at least ten days' advance notice of any record date fixed in connection with an offering of listed securities to shareholders.
- **NYSE Rule 703.03(C).** The NYSE requires issuers to send written notice to shareholders at least ten days in advance of the proposed record date. The notice should state that the issuer intends to make a rights offering. The notice should also include to the extent finally determined: (1) the title of the security to be offered; (2) the proposed subscription ratio; (3) the proposed subscription price; (4) the proposed record date for determination of those entitled to subscribe; (5) the proposed expiration date of the right to subscribe; and (6) the expected date on which the subscription certificates will be mailed.
- **NYSE Rule 703.03(E).** The NYSE requires that shareholders of listed securities be allowed at least 16 days after the rights have been mailed to subscribe to the offering, although it could be reduced to fourteen days if certain mailing conditions are met. Further, it is recommended that subscription certificates be issued to stockholders as soon as practicable after the record date.

- **NYSE Rule 703.03(M).** The NYSE requires that the issuer notify it by telephone immediately upon receiving notice that the registration of the offered securities has become effective.
- **NYSE Rule 703.03(N).** It is highly recommended that the issuer list rights, if they are transferable, in addition to listing the new shares on the exchange.
- **NYSE Rule 703.03(A).** It is recommended that the issuer confer with its exchange representative well in advance of the offering date to ensure coordination of actions and arrangement of a time schedule.
- **NYSE Rule 703.03(D).** It is recommended that (1) the effective date be set for at least 6 business days in advance of the record date in order to prevent confusion if there is a delay in the effectiveness of the registration statement, unless the issuer already has an effective shelf registration statement and (2) the issuer's board of directors establish the record date as a specified date "or such later date as registration under the Securities Act of 1933 shall become effective." It is required that once the record date is set for the rights offering, no other record date for any other purpose should be set by the issuer between the record date for the subscription offering through at least 7 business days after the expiration of the offering period.

Comparing a Rights Offering with a PIPE Transaction

With public companies, a rights offering is a form of public offering that may have comparable characteristics to private investment in public equity (PIPE) transactions. Rights offerings offer a number of advantages compared to PIPE transactions. For example, rights offerings typically have no shareholder approval requirements. Therefore, rights offerings can be completed more quickly than other forms of financing and can be a cheaper source of pre-filing and post-filing capital raising for issuers contemplating, or emerging from, Chapter 11 bankruptcies.

Additional comparisons between rights offerings and PIPE transactions are offered on the following page.

Differences	Rights Offerings	PIPE Transaction
Stockholder approval	No. Even if the rights offering results in an issuance of common stock representing 20% or more of the voting power outstanding before the issuance unless there is a standby purchaser.	Yes. If more than 20% of the pre-transaction total outstanding shares are being issued at a discount or if the transaction represents a change of control.
Usual marketing materials	Less marketing required, since the offering is made to existing shareholders. The issuer must file a prospectus or prospectus supplement, as the case may be, with the SEC.	Investors will typically rely on the issuer's public filings.
Purchase agreement between the issuer and each investor	Not required. There will be a standby agreement in transactions involving a standby purchaser.	Yes. Purchase agreements are entered into by investors, committing them to purchase a fixed number of shares at a fixed price.
When offered, securities may be transferred	A majority involve non-transferable rights.	Securities are restricted, may be resold in other exempt transactions or pursuant to an effective resale registration statement.

Checklist of Key Questions

- ✓ Has the issuer made a decision as to whether it will use a direct rights offering or a standby rights offering?
- ✓ Does the issuer have enough authorized and unissued shares to accommodate the number of shares that will be issued in connection with the rights offering?
- ✓ Will the rights be transferable?
- ✓ Will there be a standby purchaser, and who will act as a standby purchaser?
- ✓ How will the standby purchaser be compensated?
- ✓ If there is a standby purchaser, will the securities exchange rules require shareholder approval to be obtained?
- ✓ Will the issuer retain a dealer-manager or other third parties?
- ✓ Is the rights offering being undertaken in the context of a distressed issuer that may need to provide additional disclosures?

Regulation FD

Here's the Deal:

- Regulation FD is an issuer disclosure rule that prohibits a US public company and certain persons acting on its behalf from selectively disclosing material nonpublic information about itself or its securities to certain persons outside the company unless it also discloses the information to the public.
- Timing of the required public disclosure depends on whether the selective disclosure was intentional.
- For an intentional selective disclosure, public disclosure must be made simultaneously.
- For an unintentional selective disclosure, public disclosure must be made promptly.
- The required public disclosure may be made by filing or furnishing a Form 8-K or by another method or combination of methods that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.
- Acceptable methods of public disclosure can include a press release, a news conference to which the public is granted access and for which notice and the means for access are given, a simultaneous webcast of a news conference or analyst conference call, posting of the information on the company's website or making available to the public a replay of the company's news conference or conference call.
- Consequences of failing to comply with Regulation FD may result in an enforcement action by the Securities and Exchange Commission (SEC) against the company or individuals responsible for the violation

What's the Deal?

The SEC adopted Regulation FD (for "Fair Disclosure") in August 2000 to address what the SEC, at the time, observed to be a systemic problem of public companies selectively disclosing material nonpublic information to securities analysts and institutional investors before disclosing the same information to the public. Since its adoption in 2000, Regulation FD has fundamentally reshaped the manner in which public companies communicate with analysts and investors.

Regulation FD, promulgated by the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is a disclosure rule that seeks to level the informational playing field for investors. Rule 100 of Regulation FD sets forth the general rule. Whenever an issuer or a person acting on its behalf discloses material nonpublic information to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities where it is reasonably foreseeable that the holders will trade on the basis of the information), the issuer must disclose that information to the public – simultaneously for an intentional selective disclosure and promptly for an unintentional selective disclosure. The required public disclosure may be made by filing or furnishing a Form 8-K or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary distribution of the information to the public.

Regulation FD is comprised of Rules 100 through 103.

- Rule 100 provides the basic rule regarding selective disclosure of material nonpublic information.
- Rule 101 sets forth the definitions used in Regulation FD.
- Rule 102 provides that a failure to make a disclosure required by Regulation FD cannot, on its own, be grounds for a violation of Rule 10b-5, the Exchange Act's general antifraud rule.
- Rule 103 provides that a failure to comply with Regulation FD will not affect whether the issuer is considered current or timely in its Exchange Act reports for purposes of certain filings and disclosures required under the Securities Act of 1933, as amended ("Securities Act"), or whether there is adequate current public information about the issuer for purposes of Rule 144(c) under the Securities Act.

Regulation FD Fundamentals

COMPANIES SUBJECT TO REGULATION FD

Regulation FD applies to issuers that have a class of securities registered under Section 12 of the Exchange Act and issuers that are required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies, but not other types of investment companies. The term "issuer," as defined in Rule 101(b) of Regulation FD, also excludes foreign governments and foreign private issuers, though in practice most foreign private issuers with a class of equity securities listed on a US securities exchange voluntarily comply with Regulation FD. Regulation FD does not apply to a company's initial public offering. A company that has become subject to Section 15(d)'s reporting requirements because it had a registration statement on Form S-4 become effective under the Securities Act for a registered exchange offer of debt securities is subject to Regulation FD even if its equity securities are privately held and its debt securities are not traded on a securities exchange.

PERSONS ACTING ON BEHALF OF AN ISSUER

Regulation FD also applies to a "person acting on behalf of an issuer." This term is defined in Rule 101(c) as (i) any "senior official" of the issuer or (ii) any other officer, employee or agent of the issuer who regularly communicates with securities market professionals or with security holders (this element of the definition is limited to those who "regularly" communicate with securities market professionals and security holders). Rule 101(f) of Regulation FD defines a "senior official" of an issuer as any director, executive officer, investor relations or public relations officer or other person with similar functions.

Issuers cannot circumvent Regulation FD by having a non-covered person make a selective disclosure. In the Regulation FD adopting release, the SEC noted that, based on Section 20(b) of the Exchange Act, if a senior official of an issuer directs an employee who would not otherwise be considered to be acting on behalf of the issuer to make a selective disclosure, then the senior official would be responsible for having made the disclosure.

Rule 101(c) of Regulation FD provides that any officer, director, employee or agent of an issuer who discloses material, nonpublic information in breach of a duty of trust or confidence to the issuer will not

be considered to be acting on behalf of the issuer. As a result, an issuer is not responsible under Regulation FD when one of its employees improperly trades or tips.

In Question 101.10 of the Regulation FD Compliance and Disclosure Interpretations (the "Reg FD C&DIs"), the staff of the SEC's Division of Corporation Finance (the "Staff") noted that if an issuer has a policy that limits which senior officials of the issuer are authorized to speak to persons enumerated in Regulation FD, disclosures by senior officials not authorized to speak under the policy will not be subject to Regulation FD. However, the unauthorized disclosure may trigger liability under insider trading laws.

Companies subject to Regulation FD should specify in writing which employees are authorized to speak on behalf of the company and adopt policies and procedures for responding to inquiries from analysts, investors and other securities market participants. In addition, Regulation FD policies and procedures should require any unauthorized employee who receives an inquiry from an analyst, investor or other securities market participant to refer the inquiry to the company's authorized spokespersons.

DISCLOSURES OF MATERIAL NONPUBLIC INFORMATION

Regulation FD does not define materiality. In the Regulation FD adopting release, the SEC cited and discussed the leading Supreme Court cases regarding materiality, *TSC Industries v. Northway*, 426 U.S. 438 (1976) and *Basic v. Levison*, 485 U.S. 224 (1988). Under those cases, information is considered material if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if the facts "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The Regulation FD adopting release also includes a non-exhaustive list of information or events that the SEC noted should be reviewed carefully to determine whether any such information or event, if disclosed, would likely be considered material. This list includes information and events relating to:

- Earnings information (including historical earnings information, earnings estimates and changes in previously released earnings estimates);
- Mergers, acquisitions, tender offers, joint ventures or changes in assets;
- New products or discoveries;
- Regulatory developments or developments regarding customers or suppliers, such as the acquisition or loss of a contract;
- Changes in control or management;
- Liquidity problems;
- Major litigation or other events that require the filing of a Form 8-K;
- Change in auditors or auditor notification that an issuer may no longer rely on an auditor's report;
- Events involving the company's securities, such as defaults on senior securities, redemptions of securities, repurchase plans, public or private sales of securities, stock splits, changes in dividends or changes to the rights of security holders;

- Bankruptcies or receiverships; and
- In some circumstances, confirmation of previously issued guidance.

In 2018, the SEC published interpretative guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents (*see* Release No. 33-10459). The SEC noted that information about cybersecurity risks and incidents may be material, and companies should have policies and procedures to ensure that any disclosures of material nonpublic information related to cybersecurity risks and incidents are not made selectively and that any Regulation FD required public disclosure is made simultaneously or promptly and is otherwise in compliance with the requirements of Regulation FD. This is now superseded by the SEC's final rules on cybersecurity risk management, strategy, governance and incident disclosure (*see* Release No. 33-11216).

Regulation FD also does not define the term "nonpublic." In general, information is "nonpublic" if it has not been disseminated in a manner making it available to investors generally. For information to be made public, "it must be disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information." The exact length of a "reasonable waiting period" depends on the circumstances of the dissemination.

DISCLOSURES TO SECURITIES MARKET PROFESSIONALS OR SECURITY HOLDERS

Regulation FD is not a blanket prohibition on all material nonpublic disclosures. Instead, the regulation prohibits selective disclosure of material nonpublic information only to certain categories of persons outside the issuer enumerated in Rule 100(b)(1) of the regulation. Regulation FD proscribes disclosure to the following categories of persons:

- Broker-dealers and their associated persons, including sell-side analysts (Rule 100(b)(1)(i));
- Investment advisers and institutional investment managers and their associated persons, including buy-side analysts (Rule 100(b)(1)(ii));
- Registered investment companies and unregistered private investment companies, including hedge funds and some venture capital funds, and their affiliated persons (Rule 100(b)(1)(iii)); and
- Any holder of the issuer's securities (debt or equity) if it is reasonably foreseeable that such holder will purchase or sell the issuer's securities on the basis of the selectively disclosed information (Rule 100(b)(1)(iv)).

By limiting the types of communications covered by Regulation FD to the above enumerated persons, the SEC intended to exclude business communications made in the ordinary course to strategic partners, customers and suppliers, as well as communications made to governmental agencies and the media.

Directors are not prohibited from speaking privately with shareholders. In Question 101.11 of the Regulation FD C&DIs, the Staff confirmed that Regulation FD does not prohibit an issuer's directors from speaking privately with a shareholder or group of shareholders, so long as the director does not disclose material nonpublic information to such shareholder or shareholders under circumstances in which it is reasonably foreseeable that the shareholder will purchase or sell the company's securities based on such information. Additionally, Regulation FD does not apply to disclosures made to a person who expressly

agrees to maintain the disclosed information in confidence. Under these circumstances, a private communication between a director and a shareholder would not present Regulation FD issues.

Regulation FD does not prohibit an issuer from making material nonpublic disclosures to its employees, without making public disclosure of the same. This is because employees are not persons "outside the issuer."

EXEMPT COMMUNICATIONS MADE TO SECURITIES MARKET PROFESSIONALS OR SECURITY HOLDERS

Certain communications to persons outside of the issuer enumerated in Rules 101(b)(i) through (iv) are exempt under Regulation FD and not subject to the public disclosure requirement of Regulation FD. The three categories of exempt communications are:

- Communications to a person who owes the issuer a duty of trust or confidence, such as an attorney, investment banker or accountant, otherwise known as "temporary insiders";
- Communications to any person who expressly agrees to maintain the information in confidence (there is no additional requirement that the individual agree not to trade on the information, and a promise to maintain confidentiality is sufficient); and
- Communications in connection with an offering of securities registered under the Securities Act (see "Regulation FD and Securities Offerings" below for more information).

When Regulation FD was adopted in 2000, communications to credit ratings agencies under certain conditions were exempt from Regulation FD. In 2010, the SEC repealed the express exemption for disclosures of material nonpublic information to credit rating agencies. Disclosures of material nonpublic information by an issuer or a person acting on its behalf to a credit rating agency may still be exempt under other Regulation FD exemptions. For example, if a credit rating agency has expressly agreed to maintain the disclosed information in confidence, or owes a duty of trust or confidence to the issuer, disclosures to the credit rating agency will be exempt from Regulation FD.

TIMING OF REQUIRED PUBLIC DISCLOSURE

If an issuer or a person acting on its behalf selectively discloses material nonpublic information to a person enumerated in Rule 101(b)(i) through (iv) of Regulation FD and the disclosure is not exempt, the timing of the required public disclosure depends on whether the selective disclosure was intentional or unintentional. With respect to an intentional selective disclosure, the issuer must make public disclosure of the information simultaneously. In the event of an unintentional selective disclosure, the issuer must make public disclosure of the information promptly.

Rule 101(a) of Regulation FD defines "intentional" for purposes of Regulation FD. A selective disclosure of material nonpublic information is intentional when the person making the disclosure either knows, or is reckless in not knowing, that the information being communicated is both material and nonpublic. For example, a CEO or another executive officer that makes an off-the-cuff remark when they know the information is material and nonpublic will have made an intentional disclosure even if they did not intend to make it.

Rule 101(d) of Regulation FD defines "promptly" for purposes of Regulation FD. The term means "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange) after a senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser) learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic."

PUBLIC DISCLOSURE

Under Regulation FD, the required public disclosure may be made with an Exchange Act filing, such as furnishing or filing a Form 8-K, or by a combination of disclosure methods that are reasonably designed to provide broad, non-exclusionary distribution of the information to the public. These methods can include: a press release, a news conference to which the public is granted access and for which advance notice and the means for access are given, a simultaneous webcast of a news conference or analyst conference call, posting of the information on the company's website, or making available to the public a replay of the company's news conference or conference call.

In determining whether a company's method of making a particular disclosure is reasonable, the SEC will consider all the relevant facts and circumstances—recognizing that effective methods of disclosure will differ depending on the company.

A company may use its website to effect "public disclosure" for the purposes of Regulation FD. The "Commission Guidance on the Use of Company Websites," published by the SEC in August 2008 provides guidance on the use of company websites (the "2008 Guidance"). The 2008 Guidance addresses the circumstances under which information posted on an issuer's website would be considered "public" for purposes of evaluating: (i) whether website posting of information satisfies Regulation FD's "public disclosure" requirement; and (ii) whether a subsequent selective disclosure violates Regulation FD.

Whether a company's website is a "recognized channel of distribution" that can serve as an effective means for disseminating information requires an inquiry into the steps a company has taken to notify investors that information is available on its website and the actual use by investors and the market of its website. In determining whether information disclosed solely on the company's website qualifies as "public" for Regulation FD purposes, the 2008 Guidance provides that a company should consider whether:

- The website is a recognized channel of distribution;
- The posting of information on the website disseminates the information in a manner that makes it generally available to the securities marketplace; and
- There has been a reasonable waiting period for investors and the market to react to the posted information.

Each company must evaluate whether the posting of information on its website meets the simultaneous or prompt timing requirements of Regulation FD for public disclosure once a selective disclosure has been made.

The SEC has recognized social media as a legitimate means for "public disclosure" for purposes of Regulation FD. On April 2, 2013, the SEC issued a "report of investigation" that provides meaningful

guidance for companies that wish to use social media platforms such as Twitter and Facebook to publicly disseminate material information. The SEC emphasized that the appropriateness of a public disclosure through social media depends on the facts and circumstances and that companies should apply the 2008 Guidance when considering whether a social media channel is in fact a "recognized channel of distribution." Relevant factors might include that investors receive notice from the company that they intend to use social media to disseminate material information on this platform. It is clear from SEC guidance that every situation will be evaluated based on its own facts. Disclosure of material nonpublic information on the personal social media site of an individual corporate officer, without advance notice to investors that the social media site may be used for this purpose, would not likely qualify as an acceptable method of public disclosure for purposes of Regulation FD compliance.

In Question 102.05 of the Reg FD C&DIs, the Staff confirmed that an issuer cannot satisfy Regulation FD's public disclosure requirement by disclosing material nonpublic information in a speech at a shareholder meeting that is open to the public if the meeting is not webcast or broadcast by any electronic means. According to the Staff, a meeting that is open to the public but not otherwise webcast or broadcast by any electronic means is not a method of disclosure reasonably designed to provide broad, non-exclusionary distribution of the information to the public.

Regulation FD and Securities Offerings

Regulation FD generally does not apply to company communications and disclosures made in connection with an offering of securities registered under the Securities Act. This exemption is not available for certain registered shelf offerings, including secondary offerings, employee benefit plan offerings, and offerings of warrants and other convertible securities. Disclosures made in connection with a registered offering within defined starting and ending points of the offering are exempt. Rule 101(g)(1) of Regulation FD explains when, for these limited purposes, registered underwritten offerings begin and end. Rule 101(g)(2) of Regulation FD defines when registered non-underwritten offerings begin and end.

In Question 101.07 of the Reg FD C&DIs, the Staff confirmed that road show disclosures made in connection with registered public offerings are not subject to Regulation FD. Disclosures in a non-deal road show (a road show made while the company is not in registration or not otherwise engaged in a securities offering) are subject to Regulation FD. If, however, those who receive non-deal roadshow information expressly agree to keep the material nonpublic information confidential, disclosure to these persons is not subject to Regulation FD.

There is no exemption from Regulation FD for disclosures made in connection with an exempt (private) offering. A reporting company subject to Regulation FD that is making a private offering must consider carefully the Regulation FD issues that may arise in connection with its discussions regarding the private offering. Any material information that is privately disclosed to investors or potential investors must be disclosed in a Regulation FD-compliant manner, or the company must require that those who receive such information agree to maintain it in confidence. Investors in a private offering may be unwilling to expressly agree to keep material nonpublic information confidential because if they do so, they have a duty to "disclose or abstain from trading" under Rule 10b-5. As a result, they would be prohibited from trading in the securities of the company undertaking the offering until the company publicly discloses the information.

Disclosures that companies make in connection with proxy solicitations or tender offers are also not exempt from Regulation FD. A reporting company subject to Regulation FD must consider whether statements or commitments it makes in the context of soliciting proxies or opposing a third-party tender offer involve material nonpublic information within the scope of Regulation FD. This applies even though a person soliciting in opposition to a company or conducting a hostile tender offer is not subject to a corresponding requirement under Regulation FD.

Regulation FD does not give rise to an affirmative duty for the company to make a public disclosure. Instead, Regulation FD is meant to provide fair access once a company has made selective disclosures of material nonpublic information. Reporting companies subject to Regulation FD should heed their pattern of disclosures and should, in the context of a securities offering, give special consideration to the timing of their disclosures. However, the "bad news" doctrine still provides important guidance in this regard.

The "bad news" doctrine is the basic concept that a company does not have an affirmative obligation to make real time disclosures. For example, a company has no affirmative duty to disclose bad news. A public company only has an affirmative duty to disclose as required by Form 8-K for certain triggering events, only to the extent it is making its Exchange Act filings, and must provide disclosures that are not misleading, and when it is conducting a securities offering (again to ensure that it has not made disclosures that are misleading).

Enforcement of Regulation FD

Since enactment in 2000, Regulation FD has been the basis for the SEC periodically bringing enforcement actions against public companies and individuals who have violated the rule. Regulation FD is a disclosure rule and not an antifraud rule. Issuers and their individual personnel responsible for the violation of Regulation FD can be subject to an SEC enforcement action. The SEC could seek an injunction or impose fines, along with the attendant obligations to disclose the violation.

There are several important limitations to potential enforcement:

- Only conduct that is knowing or reckless can constitute a violation, as Regulation FD is a disclosure rule and not an antifraud rule.
- A finding that a company has violated Regulation FD does not automatically give rise to liability under other SEC rules. Rule 102 of Regulation FD expressly states that the failure to make a public disclosure under Regulation FD does not in and of itself constitute a Rule 10b-5 violation.
- There is no private right of action under Regulation FD. Individual plaintiffs, including shareholders, cannot make a claim based on a company's violation of Regulation FD.

Rule 103 of Regulation FD expressly states that a violation of Regulation FD will not cause a company to forfeit its Form S-3 eligibility, nor will the violation prevent a shareholder from making sales of securities under Rule 144.

Regulation FD enforcement actions are somewhat rare. The SEC has brought fewer than two dozen actions to enforce Regulation FD since its adoption. Prior to the action discussed below, only one case (*SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005)) resulted in adversarial litigation.

In March 2021, the SEC filed a lawsuit in the United States District Court for the Southern District of New York against a telecommunications company alleging that the company, aided and abetted by three executives in its Investor Relations (IR) department, repeatedly violated Regulation FD by disclosing the company's projected and actual financial results during one-on-one phone calls the three IR defendants had with analysts at approximately Wall Street firms. The company contested the allegations and argued that, among other things, the SEC could not establish any of the elements of a Regulation FD violation.

In September 2022, US District Judge Paul Engelmayer put the SEC and the telecommunications company on notice that, unless the parties reached a pretrial settlement, they were headed to trial, and, in a 129-page opinion, the court denied the parties' cross-motions for summary judgment. Neither party had established the absence of a genuine issue of material fact for trial, since a jury could find (based on the facts and evidence that would be presented at trial and detailed in the court's opinion) that the information allegedly disclosed to analysts was (or was not) material, nonpublic, and/or disclosed knowingly or recklessly.

In December 2022, the SEC announced that the company agreed to a $6.25 million penalty, resolving the Regulation FD charges against the company and the defendants. As part of the settlement, the company and the IR defendants neither admitted nor denied the allegations. The case is notable for producing one of only two judicial decisions to apply Regulation FD in adversarial litigation since Regulation FD's adoption.

The case represented only the second SEC Regulation FD enforcement action since 2013 and could reveal a new enforcement trend. In August 2019, the SEC brought an enforcement action against TherapeuticsMD ("TMD"), a life sciences company, alleging violations of Regulation FD for selectively communicating to sell-side analysts information about interactions between TMD and the US Food and Drug Administration regarding the potential approval of one of TMD's drugs. The case demonstrates the legal standard for determining whether information is material is fact dependent and ultimately rests on judgment calls that have to be made by companies. However, when assessing the materiality of information that has been selectively disclosed, the SEC, courts, and juries will have the benefit of hindsight.

Companies should design and implement policies and procedures addressing Regulation FD and regularly assess written Regulation FD training materials in order to mitigate the risk of violations. The SEC used the company's Regulation FD training materials against the company and the individuals named in the SEC's complaint, alleging that the three IR defendants had received regular Regulation FD training and the company's Regulation FD training materials specifically noted that the company's revenues and sales of smartphones were the types of information generally considered "material" to company investors. Public companies should be aware that the SEC may seek to review company Regulation FD training materials in the course of an investigation relating to an alleged violation.

Potential Preventive Measures

How can public companies mitigate potential risks associated with Regulation FD?

- Work with a legal team to determine the right approach to disclosing information to analysts, institutional investors, shareholders and the public and to evaluate those processes regularly in light of Regulation FD.

- Establish a comprehensive disclosure policy that emphasizes the seriousness and potential consequences of Regulation FD violations. Engage in periodic Regulation FD compliance training. In 2013, the SEC choose not to bring a Regulation FD enforcement action against First Solar Inc. (but instead only against the company officer that violated Regulation FD) in part due to the company's "environment of compliance" prior to the violation.
- A company may wish to designate the general counsel or another key employee as the point person for determining whether information is material, determining whether it already has been disclosed to the public, and answering any other questions about compliance with Regulation FD. This person should also be the contact for receiving notifications of non-intentional disclosures.
- Establish a record that collects the company's public statements (SEC filings, press releases, transcripts of conference calls, etc.) to track whether information has been disclosed to the public.
- Have a plan in place that is ready to be implemented in the event prompt corrective measures are necessary for disclosure. Establish a framework for Regulation FD disclosures so that the company is prepared to make simultaneous or prompt disclosures when required. Remember that issuers must publicly disclose material nonpublic information following an unintentional selective disclosure before the later of 24 hours or the beginning of the next day's trading on the New York Stock Exchange (regardless of whether the issuer's stock is traded on another exchange).
- Identify in advance a team that will be responsible for public disclosures. This team should be comprised of members from legal, investor relations and finance. This team should include a person who is up to date on the company's safe harbor warnings, because Regulation FD disclosures should include that language.
- Review the company's directors' and officers' insurance policy to ensure that the definition of "claim" includes an SEC investigation into alleged violations of Regulation FD. Many (and sometimes, most) of the expenses are incurred during the investigation. Review the company's indemnification agreements with directors and officers to determine if they cover costs associated with an SEC investigation.

CALLS TO, OR MEETINGS WITH, ANALYSTS

Private meetings with or calls to analysts are risky. The risk increases as the quarter progresses and is heightened when company personnel speaking with analysts, or instructing personnel to speak with analysts, have nonpublic information about the company's quarterly operating results. When speaking with analysts:

- Give the safe harbor warning for forward-looking statements.
- Tell the analyst that, in the speaker's view, he or she is not disclosing any material nonpublic information. Ensure that the analyst understands that the speaker does not intend to disclose material nonpublic information selectively.
- Consider putting together detailed scripts for the speaker to reference in meetings and other communications with analysts, including answers to anticipated questions.

- If the analyst disagrees with the speaker's assessment of the information the speaker has disclosed (and particularly if the analyst plans to write a report changing his or her rating based on the information), ask that the analyst notify the speaker before publishing the information.
- Explain that the notification is needed so that the company can determine whether it needs to make a Regulation FD disclosure so that the company does not violate Regulation FD.
- Ensure that there is more than one representative present from the company so that one person can take notes.

Other Regulation FD Considerations

One common situation that raises special concerns has been the practice of securities analysts seeking "guidance" from issuers regarding earnings forecasts. An issuer takes on a "high degree of risk under Regulation FD" when it engages in private discussion with an analyst seeking earnings guidance. "Harmless" comments that earnings match analysts' forecasts could trigger a violation of Regulation FD. Accordingly, companies should avoid providing guidance to analysts outside of methods that meet the definition of "public disclosure." Companies should consider whether it is prudent to implement a "no comment" policy regarding confirmation of prior guidance.

In Question 101.01 of the Reg FD C&DIs, the Staff addressed the extent to which a company may permissibly confirm prior public guidance on a selective basis without triggering Regulation FD's public disclosure requirement. The Staff noted that, when assessing the materiality of an issuer's confirmation of its own forecast, the issuer should consider whether the confirmation conveys any information above and beyond the original forecast and whether that additional information is itself material. That may depend on, among other things, the amount of time that has elapsed between the original forecast and the confirmation (or the amount of time elapsed since the last public confirmation, if applicable). The materiality of a confirmation also may depend on, among other things, intervening events. For example, if it is clear that the issuer's forecast is highly dependent on a particular customer and the customer subsequently announces that it is ceasing operations, a confirmation by the issuer of a prior forecast may be material, thus triggering a disclosure obligation. The Staff noted in Question 101.01 of the Reg FD C&DIs that a statement by an issuer that it has "not changed," or that it is "still comfortable with," a prior forecast is no different than a confirmation of a prior forecast. Additionally, under certain circumstances, a company's reference to a prior forecast may imply that the company is confirming the forecast.

In the event that a company does not wish to confirm the prior guidance, the C&DIs note that the company could say "no comment." Further, a company could make clear when referring to prior guidance that the guidance was provided as an estimate as of the date it was given and that it is not being updated at the time of the subsequent statement.

Checklist of Key Questions

- ✓ What does Regulation FD require?
- ✓ What is the timing for disclosure under Regulation FD?
- ✓ What constitutes "material information" for purposes of Regulation FD?
- ✓ What is "nonpublic information" for purposes of Regulation FD?
- ✓ What is recognized as "public" disclosure?
- ✓ What are preventative measures a company can take under the guidance of Regulation FD?
- ✓ What potential liabilities could result from violations of Regulation FD?
- ✓ What are specific preventative measures that a public company and its authorized spokespersons should consider when speaking with analysts?

Foreign Private Issuers

Here's the Deal:

- A foreign private issuer (FPI) is generally any foreign issuer (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the United States that meets certain specified conditions.
- An FPI seeking to raise capital publicly for the first time in the United States must register its securities, and subsequently must file with the Securities and Exchange Commission (SEC) annual and periodic reports, similar to a domestic issuer, but subject to certain disclosure and other accommodations.
- Under Rule 12g3-2(b) of the Securities Exchange Act of 1934, as amended, (the "Exchange Act"), certain FPIs are exempt from the Exchange Act's reporting obligations, provided certain conditions are met.
- Directors and officers of FPIs may still incur liability under U.S. securities laws.
- Officers, directors and shareholders of an FPI are not subject to the short-swing provisions of Section 16 of the Exchange Act. However, directors, officers and certain beneficial owners of an FPI are subject to the disclosure requirements of Section 13 of the Exchange Act.
- If an FPI no longer wishes to comply with ongoing reporting requirements, an FPI can deregister its securities by filing a Form 15F with the SEC.
- If an FPI determines that it no longer qualifies as an FPI, it is generally required to comply with rules for U.S. domestic companies beginning on the first day after the end of its fiscal year.

What's the Deal?

Foreign companies enjoy a number of benefits by becoming U.S. public companies. These benefits include increased visibility, access to the U.S. capital markets and the ability to offer equity-based compensation instruments to key employees.

However, companies may encounter obstacles when accessing capital in the United States. Becoming and remaining a U.S. public company is expensive and time-consuming and may require changing a company's operations in ways that a company would not necessarily choose absent U.S. requirements. Registering as an FPI affords foreign companies the ability to strike a healthy balance by providing access to the U.S. capital markets, while at the same time permitting foreign companies to benefit from certain disclosure, reporting and corporate governance accommodations.

Assessing FPI Status

The federal securities laws define a "foreign issuer" as any issuer that is a foreign government, a foreign national of any foreign country or a corporation, or other organization incorporated or organized under the laws of any foreign country.

An FPI is any foreign issuer (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the United States, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly of record by residents of the United States and any of the following applies:

- The majority of the issuer's executive officers or directors are U.S. citizens or residents,
- More than 50% of the issuer's assets are located in the United States, or
- The issuer's business is administered principally in the United States.

Calculating Outstanding Voting Securities. The percentage of outstanding voting securities held of record by a broker, dealer, bank or nominee for the accounts of customers residing in the United States is based on the number of separate accounts for which the securities are held in the United States. In addition, any shares reported as beneficially owned by a U.S. resident in a filing made under Section 13(d) of the Exchange Act, or any comparable reporting provision of another country, shall be treated as owned of record by U.S. residents. If an FPI has multiple voting classes and wants to determine the percentage of its voting stock held by U.S. residents, it can either calculate the voting power of those classes on a combined basis or simply calculate the number of voting securities.

A person who has permanent resident status (*i.e.*, a Green Card holder) is presumed to be a U.S. resident. The SEC Staff has explained that even individuals without permanent resident status may be deemed U.S. residents (for purposes of Rule 405 and Rule 3b-4(c)) based on tax residency, nationality, mailing address, physical presence, the location of a significant portion of the person's financial and legal relationships, or immigration status. The SEC Staff has not directed use of any one specific criteria when determining who is a U.S. resident. Rather, the SEC requires that the FPI determine the criteria it will use and apply them consistently.

Assessing whether an FPI's Executive Officer or Directors are U.S. Citizens or Residents. To determine whether a majority of an FPI's executive officers or directors are U.S. residents or citizens under Rule 405 and Rule 3b-4(c), the following factors must be assessed for each officer and director:

- The citizenship status of its executive officers,
- The residency status of its executive officers,
- The citizenship status of its directors, and
- The residency status of its directors.

Assessing an FPI's Assets. When determining if more than 50% of an FPI's assets are located in the United States, an FPI can either use the geographic segment information determined in the preparation of its financial statements or apply, on a consistent basis, any other reasonable methodology in assessing the location and amount of its assets.

Assessing Whether an FPI's Business is Administered Principally in the United States. There is no determinative factor to evaluate whether an FPI's business is administered principally in the United States. Rather, an FPI must analyze where its officers, partners or managers primarily direct, control and coordinate its activities. An FPI must review its status as an FPI on the last business day of its most recently completed second fiscal quarter. If an FPI no longer satisfies the required criteria for FPI status, it will become subject to U.S. domestic reporting requirements on the first day of its fiscal year immediately succeeding such determination.

FPI Becoming Subject to U.S. Reporting Requirements

An FPI will be subject to the reporting requirements under U.S. federal securities laws if it:

- Registers with the SEC the public offer and sale of its securities under the Securities Act of 1933, as amended (the "Securities Act"),
- Lists a class of its securities on a U.S. securities exchange, or
- Within 120 days after the last day of its first fiscal year in which the issuer had total assets that exceed $10 million and a class of equity securities held of record by either: (1) 2,000 or more persons or (2) 500 persons who are not accredited investors in the United States (or, in the case of an FPI that is a bank holding company or a savings and loan holding company, had total assets that exceeded $10 million and a class of equity securities held of record by either 2,000 or more persons).

Going Public in the United States

An FPI seeking to raise capital in the United States publicly for the first time must register its shares on Form F-1. A registration statement on Form F-1 is similar to a Form S-1 filed by U.S. domestic issuers and requires extensive disclosure about the FPI's business and operations.

Once an FPI has been subject to the U.S. reporting requirements for at least 12 calendar months, it generally may use Form F-3 to offer securities publicly in the United States. Form F-3 is a short-form registration statement (analogous to Form S-3 for U.S. domestic issuers) and may be used by an FPI if the FPI meets both the form's registrant requirements and the applicable transaction requirements. Form F-3 permits an FPI to disclose minimal information in the prospectus included in the Form F-3 by incorporating by reference the more extensive disclosures already filed with the SEC under the Exchange Act, primarily in the FPI's most recent Annual Report on Form 20-F and its Forms 6-K. The scope of the prospectus will generally depend on marketing needs as determined by the FPI and its investment bankers.

An FPI may offer any type of securities that a U.S. domestic issuer is permitted to offer.

Reporting Obligations of an FPI Once it Becomes a Reporting Company

As a reporting company, an FPI must comply with the SEC's reporting and disclosure requirements, including the periodic reporting requirements.

ANNUAL REPORT ON FORM 20-F

General. Form 20-F is unique to an FPI and can be used as an Annual Report similar to an Annual Report on Form 10-K filed by U.S. domestic issuers. The information required to be disclosed in a Form 20-F includes, but is not limited to:

- Operating results,
- Liquidity and capital resources,
- Trend information,
- Consolidated financial statements and other financial information,
- Significant business changes,
- Risk factors,
- History and development of the registrant,
- Business overview, and
- Organizational structure.

A Form 20-F is also required to contain a description of the FPI's corporate governance practices and a statement regarding those corporate governance practices that conform to its home country requirements and not those of the U.S. securities exchange on which its securities are listed. An FPI must also disclose information relating to changes in, and disagreements with, the FPI's certifying accountant. An FPI may also be required to disclose specialized information. For example, an FPI must provide specified information if it, or any of its subsidiaries, is engaged in oil and gas operations that are material to its business operations or financial position.

Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), an FPI that operates a mine in the United States is required to disclose certain specified information in its Form 20-F about mine health and safety, including any violations or orders issued under the U.S. Federal Mine Safety and Health Act of 1977. An FPI that operates mines outside of the United States is not subject to the disclosure requirements with respect to such mines. However, to the extent mine safety issues relating to non-U.S. mines are material, disclosure may otherwise be required under the SEC Rules.

The Dodd-Frank Act also requires disclosure by domestic issuers and FPIs regarding "conflict materials" originating from the Democratic Republic of Congo or an adjoining country and disclosures regarding payment made to U.S. or non-U.S. governments in connection with commercial development of oil, natural gas or minerals. Companies are required to provide conflict minerals disclosure on Form SD. All affected companies are required to file the form for each calendar year, regardless of their fiscal year end, no later than May 31 of the following year.

A Form 20-F may also be filed as a registration statement when an FPI is not engaged in a public offering of its securities but is still required to be or chooses to be registered under the Exchange Act (for example, when it reaches the holder of record threshold under Section 12(g) of the Exchange Act, and there is no other exemption available). In addition, an FPI may undertake a direct listing and list a class of its

securities on a U.S. securities exchange without raising capital by filing a Form 20-F and becoming subject to the Exchange Act. Given the SEC policy permitting issuers, including FPIs, to submit a Form 20-F for confidential review, it is now easier to undertake a direct listing.

An FPI has four months to file a Form 20-F as an annual report. However, if the Form 20-F is to be used as a registration statement in connection with a listing of an FPI's securities, or if the financial statements in the Form 20-F are to be incorporated by reference in a Form F-3 for an offering, the last year of audited financial statements may not be older than 15 months at the time of the offering or listing (defined as the time when the registration statement is declared effective). The impact of this requirement is to push an FPI to file its Form 20-F within three months of the end of its fiscal year rather than four months, particularly if the FPI is engaged in frequent or continuous offerings of its securities since it would be precluded from using its shelf registration statement for 30 days. Further, for issuers with affiliated broker-dealers, market-making resales of the issuer's securities by those dealers would no longer be registered. In the view of the SEC, the Section 4(a)(3) exemption is not available for market-making resales of an issuer's securities by an affiliated broker-dealer.

In addition, an FPI may incorporate by reference information previously filed with the SEC into any item of its Form 20-F annual report, subject to certain limitations set forth under the Exchange Act Rule 12b-23. An FPI that elects to incorporate such information by reference must, however, identify with specificity the information that is being incorporated by reference.

Financial Reporting Requirements. An FPI is required to make significant disclosures regarding its financial condition under Items 8 and 18 of its Annual Reports on Form 20-F. Item 8 of Form 20-F sets forth the financial information that must be included, as well as the periods covered and the age of the financial statements. In addition, Item 8 obligates an FPI to disclose any legal or arbitration proceedings involving a third party that may have, or may have recently had, a significant impact on the FPI's financial position or profitability, as well as any significant changes since the date of the annual financial statements (or since the date of the most recent interim financial statements).

An FPI that prepares its financial statements in accordance with the English language version of International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") in its filings with the SEC does not have to reconcile those financial statements with U.S. generally accepted accounting principles ("GAAP"). This exemption from reconciliation to U.S. GAAP applies only to IFRS as issued by IASB and not to any other accounting practices. If reconciliation is required, under Item 17, an FPI must either: (1) provide a statement of cash flows that is prepared in accordance with U.S. GAAP or IAS No. 7 or (2) furnish, in a note to the financial statements, a quantified description of the material differences between cash or fund flows reported in the primary financial statements and cash flows that would be reported in a statement of cash flows prepared in accordance with U.S. GAAP.

The above U.S. GAAP reconciliations may not be necessary where the financial statement information is for either:

- A business an FPI has acquired or plans to acquire,
- A less-than-majority-owned investee, or
- A joint venture.

If the target's or less-than-majority-owned investee's financial information is not prepared in accordance with U.S. GAAP, then such target or investee must account for less than 30% of an FPI's assets or income in order to avoid U.S. GAAP reconciliation. If, however, the target's or less-than-majority-owned investee's financial information is prepared in accordance with IFRS as issued by IASB (even if the issuer's financial statements are not prepared in accordance with U.S. GAAP or IFRS as issued by IASB), the FPI is not obligated to reconcile such financial statements with U.S. GAAP, regardless of the significance of the entity to the FPI's operations.

In the case of a joint venture, if an FPI prepares financial statements on a basis of accounting that allows proportionate consolidation for investments in joint ventures that would be accounted for under the equity method pursuant to U.S. GAAP, it may omit differences in classification or display that result from using proportionate consolidation in the reconciliation to U.S. GAAP. In order to avail itself of such omissions, the joint venture must be an operating entity, the significant financial operating policies of which are, by contractual arrangement, jointly controlled by all parties having an equity interest in the entity. Financial statements that are presented using proportionate consolidation must provide summarized balance sheet and income statement information and summarized cash flow information resulting from operating, financing and investing activities relating to its pro rata interest in the joint venture.

Item 18 of Form 20-F requires that an issuer provide all information required by U.S. GAAP and Regulation S-X, as well as the reconciling information for line items specified in Item 17(c) of Form 20-F. However, Item 18(b) of Form 20-F grants a limited exemption to the reconciliation requirement:

- For any period in which net income has not been presented on a basis as reconciled to U.S. GAAP,
- For the financial statements provided pursuant to Rule 3-05 of Regulation S-X in connection with a business acquired or to be acquired, or
- For the financial statements of a less-than-majority-owned investee.

In March 2017, the SEC made available an XBRL taxonomy for IFRS financial statements. As a result of the availability of the taxonomy, FPIs that prepare their financial statements under IFRS as issued by the IASB must file their financial statements in XBRL for fiscal years ending on or after December 15, 2017.

Subsidiaries. Where an FPI guarantees securities of its non-FPI subsidiary, the parent FPI (as guarantor) and non-FPI subsidiary (as issuer) may use an F-Series registration statement to register the offering of the securities under the Securities Act and use Form 20-F with respect to any reporting obligations, as long as certain requirements are satisfied.

Where the parent-guarantor and subsidiary-issuer are eligible to present condensed consolidated financial information in the parent-guarantor's filings, and the parent qualifies as an FPI, the parent-guarantor and its subsidiaries may use:

- An F-Series registration statement to register an offering of guarantees and guaranteed securities that are issued by a subsidiary (either domestic or foreign) that does not itself qualify as an FPI, and
- A Form 20-F with respect to any reporting obligations associated with the F-Series registration statement.

An FPI's wholly owned subsidiary may omit certain information under General Instruction I(2) (to Form 10-K) from its Form 20-F annual report, as long as the registrant includes a prominent statement on the Form 20-F's cover page:

- That it satisfies the conditions set forth under General Instruction I(1)(a) and (b) to Form 10, and
- Is therefore filing the Form 20-F with a reduced disclosure format.

REPORTS ON FORM 6-K

In addition to an Annual Report, an FPI must furnish Forms 6-K to the SEC from time to time. Generally, a Form 6-K contains information that is material to an investment decision in the securities of an FPI and may include press releases, shareholder reports and other materials that an FPI publishes in its home country in accordance with home-market law or custom, as well as any other information that the FPI may want to make publicly available.

Reports on Form 6-K generally take the place of Quarterly Reports on Form 10-Q (which include financial reports) and Current Reports on Form 8-K (which include disclosure relating to the occurrence of material events) that U.S. domestic issuers are required to file. Unlike Form 10-Q or Form 8-K, there are no specific disclosures required by Form 6-K.

Information provided in an FPI's Form 6-K is deemed "furnished" for purposes of the U.S. federal securities laws and is therefore not automatically incorporated by reference into an FPI's registration statement on Form F-3. If an FPI wants to incorporate a Form 6-K into its registration statement on Form F-3, it must specifically provide for its incorporation by reference in the registration statement and in any subsequently submitted Forms 6-K.

CERTIFICATION REQUIREMENTS

The principal executive officer(s) and the principal financial officer(s) (or persons performing similar functions) of an FPI are obligated to make certain certifications in a company's periodic reports. These certifications must be included in an FPI's Form 20-F. Other reports filed or furnished by an FPI, such as reports on Form 6-K, are not subject to the certification requirements because they are not considered "periodic" (unlike, for example, a Form 10-Q) and not made in connection with any securities offerings. Form 20-F requires the following certifications (although certain of the certifications with respect to internal control over financial reporting are not made until the issuer has been a reporting company for at least a year):

- The signing officer has reviewed the report of the issuer,
- Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report,
- Based on the officer's knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of and for the periods presented in the report,

- The issuer's other certifying officer(s) and the signing officer are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the issuer and have:
  - Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under their supervision, to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to such officers by others within those entities, particularly during the period in which the report is being prepared,
  - Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles,
  - Evaluated the effectiveness of the issuer's disclosure controls and procedures and presented in the report their conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the report based on such evaluation, and
  - Disclosed in the report any change in the issuer's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.
- The registrant's certifying officer(s) and the signing officer have disclosed, based on their most recent evaluation of internal control over financial reporting, to the issuer's auditors and the audit committee of the issuer's board of directors (or persons performing the equivalent functions):
  - All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information, and
  - Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal control over financial reporting.

An FPI's obligation to comply with the internal control certification requirements does not begin until it is either required to file an annual report pursuant to Section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the SEC for the prior fiscal year.

An FPI that is not required to comply with Items 15(b) and (c) must include a statement in the first annual report that it files in substantially the following form:

> "*This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies.*"

The Exchange Act requires that each periodic report filed under the Exchange Act, including Form 20-F, must include the internal control certifications and must be signed by the issuer's chief executive officer and chief financial officer. Item 15 of Form 20-F contains the internal control certification requirements applicable to an FPI. Under Item 15(b), an FPI must disclose:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the FPI,
- A statement identifying the framework used by management to evaluate the effectiveness of the FPI's internal control over financial reporting,
- Management's assessment of the effectiveness of the FPI's internal control over financial reporting as of the end of its most recent fiscal year, including a statement on whether the internal control over financial reporting is effective, and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the FPI's internal control over financial reporting.

Further, under Item 15(c) of Form 20-F, every registered public accounting firm that prepares or issues an audit report on an FPI's annual financial statement must attest to, and report on, the assessment made by management. Such attestation must be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board and cannot be the subject of a separate engagement of the registered public accounting firm. However, the universal practice is for the auditors to audit management's internal control over financial reporting and not actually attest to management's assessment.

Special Accommodations for Reporting FPIs

FPIs benefit from special accommodations that are intended to reduce their reporting burdens.

ANNUAL AND QUARTERLY REPORTS

As discussed above, an FPI must file an Annual Report on Form 20-F within four months after its fiscal year ends. By contrast, a domestic issuer must file an Annual Report on Form 10-K between 60 and 90 days following the end of its fiscal year, depending on its capitalization and other factors. Similarly, an FPI is not required to file public quarterly reports, subject to certain exceptions. Companies with a class of listed securities must file semi-annual unaudited financial information under cover of a Form 6-K within six months following the end of the second fiscal quarter. By contrast, U.S. domestic issuers are required to file unaudited financial information quarterly using Form 10–Q.

PROXY SOLICITATIONS

An FPI is not required under U.S. federal securities laws or the rules of the U.S. securities exchanges to file proxy solicitation materials on Schedule 14A or 14C in connection with annual or special meetings of its shareholders.

AUDIT COMMITTEE

As discussed below, there are numerous accommodations to the nature and composition of an FPI's audit committee or permitted alternative.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Both an FPI and a U.S. domestic issuer must annually assess their internal control over financial reporting and in many instances provide an independent auditor's audit of the effectiveness of such internal control. U.S. domestic issuers are also obligated to assess changes in their internal control over financial reporting on a quarterly basis.

EXECUTIVE COMPENSATION

FPIs are generally exempt from the detailed disclosure requirements regarding executive compensation required by the SEC. However, an FPI is required to make certain disclosures regarding executive compensation on an individual basis, unless its home country laws do not require such disclosures and provided the information is not otherwise publicly disclosed by the FPI. In addition, an FPI must file as exhibits to its public filings individual management contracts and compensatory plans if required by its home country regulations or if it previously disclosed such documents.

DIRECTORS/OFFICERS EQUITY HOLDINGS

Directors and officers of an FPI do not have to report their equity holdings and transactions under Section 16 of the Exchange Act, subject to certain exceptions. However, shareholders, including directors and officers, may have filing obligations under Section 13(d) of the Exchange Act.

IFRS-NO U.S. GAAP RECONCILIATION

An FPI may prepare its financial statements in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP.

CONFIDENTIAL SUBMISSIONS FOR CERTAIN FOREIGN ISSUERS

Certain foreign issuers that are registering for the first time with the SEC may submit their registration statements on a confidential basis to the SEC Staff.

EXCHANGE ACT SECTION 16

Insiders of an FPI are not subject to the short-swing profit limits set forth in Section 16(b), nor are they required to comply with the Section 16(a) reporting requirements.

EASY TERMINATION OF REGISTRATION/DEREGISTRATION

An FPI, regardless of the number of its U.S. shareholders, may terminate its registration of equity securities under the Exchange Act and cease filing reports with the SEC, subject to certain conditions. This rule allows a U.S.-listed FPI to exit the U.S. capital markets with relative ease and terminate its reporting duties under Section 15(d) of the Exchange Act.

Disclosure Obligations by Beneficial Owners

When an FPI becomes a reporting company, its shareholders become subject to certain reporting obligations under the Exchange Act.

EXCHANGE ACT SECTION 13

Under Sections 13(d) and 13(g) of the Exchange Act and the SEC's related rules, if a beneficial owner controls more than 5 percent of a certain class of equity securities, it must deliver a statement to the issuer of the security and to each exchange on which the security is traded. Delivery to each exchange can be satisfied by making a filing on the SEC's Electronic Data-Gathering, Analysis, and Retrieval system ("EDGAR"). In addition, the beneficial owner must file with the SEC a statement containing certain information, as well as any additional information that the SEC may deem necessary or appropriate in the public interest or for the protection of investors.

EXCHANGE ACT RULE 13D-1

Rule 13d-1 mandates that a beneficial owner of a class of registered equity security must file a statement containing the information required by Schedule 13D with the SEC, within 10 business days. Schedule 13D requires certain information about shareholders, including (but not limited to):

- The identity of the shareholder,
- How many shares of the company the shareholder owns and how the shares are owned,
- The source of the funds used to buy the shares, and
- The shareholder's purpose for owning the shares.

Alternatively, certain holders of securities of an FPI may be permitted to report their beneficial ownership on Schedule 13G, pursuant to Rule 13d-1(b) of the Exchange Act. The disclosures under Schedule 13G are considerably less detailed than those required by Schedule 13D. Rule 13d-1 contemplates the filing of a Schedule 13G in lieu of a Schedule 13D in the case of a passive investor that owns less than 20 percent of a company (but more than 5 percent) and did not acquire its shares for the purpose, or with the effect, of changing or influencing control of the company. Schedule 13G requires the following disclosures:

- The identity of the shareholder,
- How many shares of the company the shareholder owns and how the shares are owned, and
- Certification that the shareholder is a passive investor.

FPIs as Emerging Growth Companies

Title I of the Jumpstart Our Business Startups (JOBS) Act, adopted in April 2012, established a new category of issuer called an emerging growth company (EGC). An EGC is defined as an issuer with total gross revenues of under $1.235 billion (adjusted from $1 billion in March 2017 and subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. A company remains an EGC until the earlier of five years or:

- The last day of the fiscal year during which the issuer has total annual gross revenues in excess of $1.235 billion (subject to inflationary indexing),

- The last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act,
- The date on which such issuer has, during the prior three-year period, issued more than $1 billion in nonconvertible debt, or
- The date on which the issuer is deemed a "large accelerated filer."

The phrase "total annual gross revenues" means total revenues as presented on the income statement under U.S. GAAP or IFRS, as issued by the IASB, if used as the basis of reporting by an FPI. If the financial statements of an FPI are presented in a currency other than U.S. dollars, total annual gross revenues for purposes of determining whether an FPI is an EGC should be calculated in U.S. dollars using the exchange rate as of the last day of the most recently completed fiscal year.

Under Title I of the JOBS Act, an FPI may not qualify as an EGC "if the first sale of common equity securities of such issuer pursuant to an effective registration statement under the Securities Act occurred on or before December 8, 2011." According to the SEC, the phrase "first sale of common equity securities" in the JOBS Act is not limited to a company's initial primary offering of common equity securities for cash and may also include offering common equity pursuant to an employee benefit plan (for example, pursuant to Form S-8), as well as a selling shareholder's secondary offering on a resale registration statement.

If an FPI had a registration statement declared effective on or before December 8, 2011, it can qualify as an EGC (provided the other requirements of the definition are satisfied) so long as the first sale of common equity securities occurs after December 8, 2011. An FPI that is a public company outside of the United States may also qualify as an EGC provided it meets the EGC requirements set forth above.

For FPIs that are EGCs, the JOBS Act allows for a streamlined IPO "on-ramp" process in order to phase-in some of the more comprehensive and costly disclosure requirements. For instance, an EGC has the option to do the following:

- *Confidential Submissions.* An EGC is permitted to submit a draft registration statement on Form 20-F or Form F-1, as well as any amendments, to the SEC for confidential, nonpublic review prior to the public filing, provided that the initial confidential submissions and all amendments are filed with the SEC no later than 15 days prior to the issuer's commencement of the roadshow (note: this 15-day period is not required under the SEC's confidential filing policy solely applicable to FPIs).
- *Testing-the-Waters.* An EGC is permitted to engage in oral or written communications with qualified institutional buyers, or QIBs, and institutional accredited investors in order to gauge their interest in a proposed IPO, either prior to or following the initial filing of the IPO registration statement.
- *Research Report.* A broker-dealer is permitted to publish or distribute a research report about an EGC that it proposes to register or that is in registration. The research report will not be deemed an "offer" under the Securities Act regardless of whether the broker-dealer intends on participating, or is currently participating, in the offering.

- *Audited Financials.* An EGC is required to present only two years of audited financial statements (as opposed to three years) in connection with its IPO registration statement. In any other registration statement or periodic report, an EGC need not include financial information within its selected financial data or in its Management Discussion and Analysis disclosure for periods prior to those presented in its IPO registration statement.
- *Auditor Attestation Report on Internal Control.* An EGC is exempt from the requirement to obtain an attestation report on internal control over financial reporting from its registered public accounting firm.

While the JOBS Act does not explicitly allow an FPI that is an EGC to take advantage of the disclosure accommodations, in the SEC Staff's JOBS Act FAQs, the Staff stated that it will not object to an FPI that opts to take advantage of such exemptions, provided it qualifies as an EGC.

Other Confidential Filing Processes

In its guidance from December 2011 that was updated in May 2012, the SEC Staff announced that it would review initial registration statements of a foreign issuer on a confidential basis only if such issuer is:

- A foreign government registering its debt securities,
- An FPI that is listed or is concurrently listing its securities on a non-U.S. securities exchange,
- An FPI that is being privatized by a foreign government, or
- An FPI that can demonstrate that the public filing of an initial registration statement would conflict with the laws of an applicable foreign jurisdiction.

Foreign issuers that are shell companies, blank-check companies, and issuers with no, or substantially no, business operations are not permitted to confidentially submit their initial registration statements. In addition, the SEC Staff has stated that there may be circumstances in which the Staff will request that a foreign issuer publicly file its registration statement even though it comes within the general parameters of the policy. Examples of these circumstances include a competing bid in an acquisition transaction or publicity about a proposed offering or listing.

Throughout 2012, the SEC sought to harmonize the confidential submission process for FPIs and EGCs. Since October 2012, both FPIs and EGCs are required to submit draft registration statements and response letters to Staff comments through EDGAR. When the FPI or EGC publicly files its registration statement, all previously submitted draft registration statements will become publicly available and all Staff comment letters and issuer response letters will be posted on EDGAR in accordance with Staff policy. However, unless the FPI is seeking to be treated as an EGC, it will not be required to publicly file its registration statement (and the prior confidential submissions) at least 15 days before commencement of the roadshow for the offering.

As of July 2017, the SEC announced that it will accept draft registration statements from all companies for confidential review. As is the case for EGC IPO issuers, any issuer that avails itself of the confidential submission process for its IPO must publicly file its registration statement at least 15 days before the date on which the issuer conducts a roadshow.

An FPI may elect to submit a draft registration statement for confidential review in accordance with these expanded procedures, those available to EGCs or the May 2012 guidance.

Exempt Offerings in the U.S. Capital Markets

There are a number of alternatives an FPI can use to raise capital that do not require registration with the SEC, such as private placements under Section 4(a)(2) of the Securities Act and Rule 144A offerings.

PRIVATE PLACEMENTS

Under Section 4(a)(2) of the Securities Act, the registration and related prospectus delivery requirements under Section 5 of the Securities Act do not apply to "transactions by an issuer not involving any public offering." The statute itself provides little guidance as to the types of transactions that fall within the scope of Section 4(a)(2). However, judicial and regulatory interpretations have produced a flexible, fact-specific analysis of the types of transactions that could be deemed private offerings, based on the following elements:

- A limited number,
- Of financially sophisticated offerees,
- Given access to information relevant to their investment position,
- That have some relationship to each other and to the issuer, and
- That are offered securities in a manner not involving any general advertising or solicitation.

It is important to note that the Section 4(a)(2) exemption is available only to the issuer of the securities. This exemption is not available for the resale of securities purchased by investors in a private placement. The issuer claiming the Section 4(a)(2) exemption has the burden of establishing that the exemption is available for the particular transaction. If securities are sold without a valid exemption from registration, Section 12(a)(1) of the Securities Act gives the purchaser the right to rescind the transaction for a period of one year after the sale. The rescission right may be exercised against anyone involved in the sale of the security, including the issuer and any broker-dealer that may have acted as the financial intermediary or placement agent in connection with the offering. Further, any transaction that is not deemed exempt under Section 4(a)(2) will be treated as an unregistered public offering, and the issuer may be subject to liability under U.S. federal securities laws.

RULE 144A OFFERING

Rule 144A provides a nonexclusive safe harbor from the registration and prospectus delivery requirements of Section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. The safe harbor is based on two statutory exemptions from registration under Section 5 of the Securities Act: Section 4(a)(1) and Section 4(a)(3). In summary, Rule 144A provides that:

- For sales made under Rule 144A under the Securities Act by a reseller, other than the issuer, an underwriter or a broker-dealer, the reseller is deemed not to be engaged in a "distribution" of those securities and, therefore, not to be an "underwriter" of those securities within the meaning of Section 2(a)(11) and Section 4(a)(1) of the Securities Act, and

- For sales made under Rule 144A under the Securities Act by a reseller that is a dealer, the dealer is deemed not to be a participant in a "distribution" of those securities within the meaning of Section 4(a)(3)(C) of the Securities Act and not to be an "underwriter" of those securities within the meaning of Section 2(a)(11) of the Securities Act, and those securities are deemed not to have been "offered to the public" within the meaning of Section 4(a)(3)(A) of the Securities Act.

A Rule 144A offering usually is structured so that the issuer first sells the newly issued restricted securities to an "initial purchaser," typically a broker-dealer, in a private placement exempt from registration under Section 4(a)(2) or Regulation D. Rule 144A then permits the broker-dealer to immediately reoffer and resell the restricted securities to a category of the largest and most sophisticated investors known as qualified institutional buyers ("QIBs") or to persons and entities that the issuer reasonably believes are QIBs.

Corporate Governance

The primary sources for U.S. corporate governance rules are:

- The Securities Act,
- The Exchange Act,
- The rules, regulations and other guidance issued by the SEC, and
- The listing standards and rules for listed companies published by U.S. securities exchanges.

An FPI registered in the United States may also continue to follow certain corporate governance practices in accordance with its home country rules and regulations. The SEC and the U.S. securities exchanges acknowledge the disparities between domestic and foreign governance practices and the potential cost of conforming to U.S. standards. Accordingly, an FPI may choose to rely on exemptions from certain corporate governance requirements and rely on its home country governance practices (particularly with respect to audit committee and compensation committee requirements).

AUDIT COMMITTEES

The SEC provides exemptions to its independence requirement for Audit Committee members in order to accommodate the following global practices:

- *Employee representation:* If a non-management employee is elected or named to the board of directors or audit committee of an FPI pursuant to the FPI's governing law or documents, an employee collective bargaining or similar agreement, or other home country legal or listing requirement, he or she may serve as a committee member.
- *Two-tiered board systems:* A two-tiered system consists of a management board and a supervisory/non-management board. The SEC treats the supervisory/non-management board as a "board of directors" for purposes of Rule 10A-3(b)(1) of the Exchange Act. As such, an FPI's supervisory/non-management board can either form a separate audit committee or, if the supervisory/non-management board is independent, the entire supervisory/non-management board can be designated as the audit committee.

- *Foreign government representation:* In some instances, a foreign government may be a significant shareholder or own special shares that entitle the government to exercise certain rights related to an FPI. The SEC permits a representative of a foreign government or foreign governmental entity to be an audit committee member, subject to certain conditions.
- *Board of auditors:* The SEC permits auditor oversight through a board of auditors, subject to certain conditions.

The U.S. securities exchanges, such as the New York Stock Exchange ("NYSE") and Nasdaq, also impose rules and regulations governing audit committee composition and disclosures for companies that list on their exchanges. Like the SEC, each exchange provides exemptions for an FPI that wishes to follow its home country practices in lieu of the U.S. securities exchange rules. For example, under Nasdaq rules, an FPI opting to follow its home country audit committee practices is required to submit a letter from home country counsel certifying its practice is not prohibited by home country law. An FPI is required to submit such a letter only once, either at the time of initial listing or prior to the time the FPI initiates a nonconforming audit committee practice. Similarly, under the NYSE Listed Companies Manual, an FPI may follow its home country audit committee practice, provided it:

- Discloses how its corporate governance practices differ from those of domestically listed companies,
- Satisfies the independence requirements imposed by Section 10A-3 of the Exchange Act,
- Certifies to the NYSE that the FPI is not aware of any violation of the NYSE corporate governance listing standards, and
- Submits an executed written affirmation annually or an interim written affirmation each time a change occurs to the FPI's board or any of its committees, and includes information, if applicable, indicating that a previously independent audit committee member is no longer independent, that a member has been added to the audit committee, or that the FPI is no longer eligible to rely on, or has chosen not to continue to rely on, a previously applicable exemption to the audit committee independence rules.

COMPENSATION COMMITTEES

Form 20-F requires an FPI to disclose information regarding its compensation committee, including the names of the committee members and a summary of the terms under which the committee operates. Similar to audit committees, both the NYSE and Nasdaq permit an FPI to follow home country practices with respect to its compensation committee.

Liability Under U.S. Securities Laws

SECURITIES ACT SECTION 11

Directors and officers of an FPI who sign a registration statement filed in connection with a securities offering are subject to the liability provisions of Section 11 of the Securities Act. Section 11 of the Securities Act creates civil liability for misstatements or omissions in a registration statement at the time it becomes effective. Any person that acquired a security registered under a registration statement and that did not have knowledge of the misstatement or omission at the time of the acquisition of the security can

WHAT'S THE DEAL? FOREIGN PRIVATE ISSUERS

bring suit against: (1) every person who signed the registration statement, including the issuer, (2) every director of the issuer at the time of the filing of the registration statement, whether or not such director signed the registration statement, (3) experts who consent to the registration statement, but only with respect to those sections which they have "expertized," and (4) underwriters. In addition, Section 15 of the Securities Act permits a plaintiff in an action for damages under Section 11 to assert claims against any person who controls any of the foregoing persons, including controlling shareholders who are not also officers and directors of the issuer, by or through the ownership of stock or an agency relationship.

Section 11 is a strict liability provision. Therefore, a plaintiff is not required to prove intent or knowledge with respect to a misstatement or omission in a registration statement. In addition, a plaintiff bringing a cause of action under Section 11 does not have to show reliance on a misstatement or omission. However, reliance must be established if the plaintiff purchased the securities after the publication of an earnings statement covering a 12-month period after the effective date of the registration statement.

Section 11(e) limits the amount of recoverable damages to the difference between the price paid (not to exceed the public offering price) and (1) the value of the security as of the time the suit was brought, (2) the price at which the security would have been disposed of in the open market before the suit or (3) the price at which the security would have been disposed of after the suit but before judgment, if the damages would be less than the damages representing the difference between the amount paid for the security (not to exceed the public offering price) and the value of the security at the time the suit was brought, subject to certain exceptions. Section 11, however, also provides that defendants may reduce the amount of damages by proving that the market depreciation of the securities was due to factors other than the misstatement or omission.

In the case of private placements, an FPI may be subject to liability under Section 11 and Section 12 (discussed below) of the Securities Act if the court determines that the "private placement" was actually a public offering and that the registration requirements of the Securities Act were not satisfied.

SECURITIES ACT SECTIONS 12 AND 13

Section 12 of the Securities Act assigns liability to any person who offers or sells a security in violation of Section 5 of the Securities Act (pursuant to Section 12(a)(1)) or by means of a prospectus or oral communication that includes a misstatement or omission of material fact (pursuant to Section 12(a)(2)). Plaintiffs bringing a claim under Section 12 are afforded rescission rights, if they still have ownership of the securities, or damages, if they no longer own the security.

Note that no action under Section 11 or Section 12(a)(1) may be brought more than three years after the bona fide public offering of a security or, in the case of Section 12(a)(2), more than three years after the actual sale of a security.

EXCHANGE ACT RULE 10b-5

Rule 10b-5 of the Exchange Act prohibits: (1) the use of any device, scheme or artifice to defraud, (2) the making of any untrue statement of a material fact or the omission of a material fact necessary to make the statements made not misleading, or (3) the engaging in any act, practice or course of business that would operate to deceive any person in connection with the purchase or sale of any securities. To bring a successful cause of action under Rule 10b-5, the plaintiff must prove (i) that there was a misrepresentation or failure to disclose a material fact, (ii) that was made in connection with plaintiffs' purchase or sale of a security, (iii) that defendants acted with "scienter," or the intent or knowledge of the violation, (iv) that plaintiffs "relied" on defendants' misrepresentation or omission and (v) that such misrepresentation or omission caused plaintiffs' damages.

An FPI may also be subject to liability under Section 10b-5 for material misstatements and omissions made in connection with a private placement.

EXCHANGE ACT REGULATION M

An FPI is subject to Regulation M under the Exchange Act. Regulation M prohibits any participant in a distribution of securities from purchasing any security or securities of the same class or series until the participant has completed its participation in the distribution. Regulation M is designed to prevent market priming or stock price manipulation in a distribution of securities. Potential participants covered under Regulation M include the issuer, underwriters, placement agents, brokers, dealers, control persons, selling shareholders, and officers and directors. Regulation M does allow for certain exemptions, and the SEC may grant additional exemptions upon request.

Losing FPI Status

If a reporting FPI determines that it no longer qualifies as an FPI, it must come into compliance with the registration and reporting requirements of U.S. domestic companies beginning on the first day of the next fiscal year. Under those circumstances, the FPI could typically continue using the registration and reporting forms for FPIs until the end of its fiscal year.

If, however, an FPI no longer meets the definition of an FPI because it incorporates in a U.S. jurisdiction, then it must immediately begin filing reports under the Exchange Act as a U.S. company.

The NYSE generally provides for a six-month transition period for most of its FPI accommodations when a company loses its FPI status. Nasdaq does not specify a transition period.

Deregistering Securities

Complying with the ongoing reporting obligations imposed by the Exchange Act is both expensive and labor intensive. FPIs who elect to deregister securities may save time and money by removing requirements imposed by the Exchange Act and The Sarbanes-Oxley Act of 2002. Deregistration can be done by filing a Form 15F with the SEC.

Upon deregistering securities, an FPI must also delist any securities listed on an exchange. Rule 12d2-2 of the Exchange Act permits an FPI to withdraw a class of securities from being listed on a U.S. securities exchange and/or from registration under Section 12(b) of the Exchange Act. To delist a security from a national exchange, an FPI must file an application to withdraw from listing on the exchange via Form 25. Such application will become effective 10 days after the form is filed with the SEC. An application to withdraw registration of a class of securities under Section 12(b) will become effective within 90 days after the form is filed.

An FPI must also provide notice of its intention to deregister either before or on the date it files a Form 15F. Notice must be published "through a means reasonably designed to provide broad dissemination of the information to the public in the United States." The FPI must also submit a copy of the notice to the SEC, via Form 6-K before or at the time of filing of the Form 15F or as an exhibit to the filed Form 15F.

Checklist of Key Questions

- ✓ How does an issuer qualify as a FPI?
- ✓ How can an FPI offer securities publicly in the United States?
- ✓ What type of securities can an FPI offer in the United States?
- ✓ What Exchange Act filings must an FPI make with the SEC?
- ✓ When can an FPI follow its home country rules with respect to corporate governance?
- ✓ How can an FPI raise capital through exempt offerings?
- ✓ When is an FPI exempt from Exchange Act reporting requirements?
- ✓ In what ways can directors and officers of an FPI be subject to liability under U.S. federal securities law?
- ✓ How can an FPI deregister its securities?
- ✓ What reporting obligations are imposed on directors, officers and significant security holders of an FPI?
- ✓ How can an FPI come into compliance with reporting requirements for domestic companies if it loses its status as an FPI?

Here's the Deal:

- What are special purpose acquisition companies (SPACs)?
- Why are SPAC initial public offerings (IPOs) popular?
- What is the typical capital structure of a SPAC after its IPO and prior to completion of the initial business combination or merger?
- Why should a private operating company consider merging with/into a SPAC?
- Are SPACs blank check companies or shell companies?
- How would this affect the ability of the SPAC to engage in roadshow and other outreach efforts?
- What securities law considerations should operating companies consider when evaluating a merger with a SPAC?
- What are some of the factors considered by the securities exchanges with respect to the number of holders of SPAC common stock and warrants?

What's the Deal?

SPACs, commonly referred to as "blank check companies," are public shell companies that use their IPO proceeds in order to acquire private companies within a specific time frame (this acquisition is commonly referred to as an "initial business combination" and the merger or combination transaction is often referred to as the "de-SPACing transaction"). Although SPACs have existed for decades, merging into a SPAC has recently become an attractive alternative for private companies in lieu of undertaking traditional IPOs. Today, SPACs have higher quality sponsors, more blue-chip investors, bulge bracket underwriters and better sponsor-investor alignment structures than the past. These factors have contributed to making SPACs more mainstream investment vehicles and accounted for approximately 20% of IPO proceeds in 2019, 49% of IPO proceeds in 2020 and 51% of IPO proceeds in 2021. SPACs raised approximately $144 billion in 2021, a 91% increase from the $75.5 billion raised in 2020, and much higher than 2019's record of approximately $13.6 billion. The SPAC market has experienced a downturn after 2022. SPAC IPOs raised $3.9 billion in 2023 and $9.6 billion in 2024.

How SPACs Work

Not all SPACs are the same. Some SPACs are focused on completing an acquisition in a particular geography or industry, while some have no such mandate. However, SPACs cannot identify specific private companies as targets pre-IPO. Post-IPO, SPACs place 100% of their IPO proceeds in an interest-bearing trust account, which is generally accessible only to complete an initial business combination or redeem investors under certain conditions. In order to compensate investors for this illiquidity, SPACs offer investors units, each of which is comprised of common stock and whole or fractional warrants in order to acquire additional common stock in the future. The warrants are typically priced "out of the money" (*i.e.*, at a higher price than the IPO offering price of the unit). Shortly following the IPO, the common stock and the warrants trade separately alongside the units.

In general, the sponsor receives 20% of the SPAC's common stock (the "founder's shares") following the SPAC's IPO for nominal consideration as compensation. The founder's shares typically are subject to a lock-up agreement until the initial business combination is completed. The sponsor also purchases warrants to fund the costs associated with the SPAC's IPO, such as underwriting fees, in a private placement occurring in conjunction with the IPO (the "at risk capital"). The nominal consideration used to purchase the founder's shares are held in a trust account. Sponsors typically do not receive management fees until the initial business combination is completed.

As mentioned briefly above, SPACs must use their IPO proceeds in order to acquire private companies, or its "targets," within a specific time frame, which is typically 18-24 months. Although some SPACs may include an option to extend this deadline (*e.g.*, through a shareholder vote), SPACs must liquidate trust accounts and redeem investors (plus interest) should they fail to acquire a target within the specified time frames. The founder's shares are not redeemed for cash upon liquidation, which encourages sponsors to find a suitable target.

Once a sponsor identifies a target, the SPAC requires shareholder approval to complete the proposed initial business combination. The SPAC also will offer investors the election either to redeem their common stock for the original purchase price plus interest or to sell their common stock to the SPAC in a tender offer. Investors may redeem their common stock regardless of a vote for or against the merger, and investors may hold their warrants even if they redeem their common stock. Once a merger is announced, the sponsor will seek to obtain the required approvals for the proposed transaction, and the merger with the target company is generally referred to, as noted above, as "de-SPACing." Following completion of the merger, the operating company is the surviving public company.

Advantages for an Operating Company of Merging into a SPAC

For an operating company, merging with and into a SPAC may be faster than undertaking a traditional IPO; however, this will depend upon the nature of the negotiations between the SPAC and the operating company and the shareholder approval process. An operating company should take into account that merging with a SPAC will require significant management time and resources. The process entails the negotiation of a merger agreement and related ancillary documents, which will be time consuming. In addition, in connection with the solicitation of shareholder approval by the SPAC for the merger transaction, the operating company will be required to prepare disclosures about its business, including risk factors, operating results and management. Following completion of the SPAC merger, the operating company will be required to comply with public company corporate governance requirements. For a private company, going public through a SPAC merger may provide greater certainty with respect to valuation than undertaking a traditional IPO. The merger consideration (and the valuation for the private company) is set when the merger agreement is executed. Although a repricing may be possible as a result of market volatility or for other reasons.

In connection with the SPAC merger, the SPAC will communicate with its shareholders and with other market participants regarding the merger. Given that these are business combination related discussions and not communications related to an IPO, there may be greater flexibility relating to the content and timing of the communications.

Disadvantages of SPACs

Historically, there has been concern regarding the alignment of interests between SPAC sponsors and SPAC shareholders. Given that sponsors generally receive 20% of a SPAC's common stock for nominal compensation, sponsors may profit even if a future acquisition proves unsuccessful. More recently, there have been some changes in the SPAC structure. Most notably, in the SPAC sponsored by Bill Ackman, the SPAC sponsor will forego all founder's shares.

SPACs also create significant arbitrage opportunities that can impede long-term investing. Traditionally, hedge funds invested in SPACs because SPACs allowed investors to keep their warrants even if they redeemed their common stock. Redemption rights also create inherent uncertainty about the amount of funds available to the SPAC to complete an acquisition. Recently, many SPACs have mitigated this concern by issuing additional equity or equity-linked securities usually contingent upon the merger closing in a private placement or a private investment in public equity ("PIPE") transaction. A capital-raising transaction also may provide additional capital for the operating company to deploy to fund its continued growth.

There is also the possibility that market participants may not like the proposed business combination. Over half of the companies that have emerged from a merger with a SPAC have experienced poor aftermarket performance. Over time, this trend may reverse itself as more SPACs are completed, and the more recent SPACs are larger and led by better-known sponsor groups, which may lead to greater long-term success. The operating company also may want to consider how it will establish a relationship with investment banks that will be in a position to provide equity research coverage and make a market in the securities of the operating company following completion of the transaction. While a SPAC will undertake investor outreach in connection with soliciting shareholder approval of the merger transaction, these investor meetings may not be sufficient to develop a familiarity among institutional investors with the operating company. During a traditional IPO process, and perhaps in the private placements preceding many IPOs, the IPO issuer will have an opportunity to meet with and form relationships with institutional investors that are committed to or interested in the IPO issuer's sector. Last, SPACs will incur significant costs.

Securities Law Considerations for SPAC IPOs

EXEMPTION FROM "BLANK-CHECK COMPANY" STATUS UNDER RULE 419

SPACs are designed to avoid being classified "blank-check companies" under the securities laws. This is because under Rule 419 under the Securities Act of 1933, as amended (the "Securities Act"), a blank-check company must, among other things, deposit all proceeds and securities issued in its IPO into an escrow account, and there is a prohibition from transferring or trading the securities until after completion of a business combination. Although depositing funds into an escrow account has become market practice for SPACs, it would be a hindrance to restrict trading pending the completion of a business combination (the documentation for most SPACs allows up to 24 months for the SPAC to complete this process). To be deemed a blank-check company, the issuer must issue "penny stock," as defined in Rule 3a51-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Exchange Act Rule 3a51-1(g) excludes from the definition of penny stock any security of an issuer that has been in operation for less than three years and has at least $5 million in net tangible assets. In order to benefit from this exclusion, the SEC requires that the issuer file a Form 8-K with an audited balance sheet as soon as practicable after the IPO demonstrating compliance. Generally, SPACs use the Exchange Act Rule 3a51-1(g) exclusion and avoid Rule 419's requirements.

Typically, a SPAC's IPO registration statement will state that the SPAC will file such a Form 8-K promptly after consummation of the IPO. If an overallotment option is exercised after the filing of this Form 8-K, the SPAC will need to file an additional Form 8-K with an updated audited balance sheet reflecting the overallotment exercise. The underwriting agreement also typically contains covenants that require the SPAC to file the Form 8-K.

SPACs AS SHELL COMPANIES AND INELIGIBLE ISSUERS

While exempt from Securities Rule 419, a SPAC is considered a "shell company" under Securities Act Rule 405. As a consequence:

- A SPAC is an "ineligible issuer," as defined in Securities Act Rule 405, and thus may not use free writing prospectuses (without the benefit of the free writing prospectus rules, roadshow presentations are subject to additional restrictions, which are discussed below);
- Holders of the SPAC's securities may not rely on Securities Act Rule 144 for resales of such securities until one year after the SPAC has completed its initial business combination and filed current Form 10 information (the SPAC must also have filed periodic reports required by Section 13 or 15(d) of the Exchange Act (other than Form 8-K reports) for the prior 12 months (or such shorter period that the SPAC was required to file such reports));
- A SPAC cannot become a well-known seasoned issuer until three years have passed since its initial business combination; and
- A SPAC cannot use many of the communications safe harbors under the Securities Act.

INVESTMENT COMPANY ACT

The structure of a SPAC's trust account is designed to avoid the SPAC being classified as an "investment company" under the Investment Company Act of 1940, as amended (the "Investment Company Act"). Following its IPO, a SPAC is typically required to invest the IPO proceeds held in trust in either government securities or in money market funds that invest only in government securities. By doing so, a SPAC may rely on Rule 3a-1 under the Investment Company Act, which excludes companies with no more than 45% of the value of its total assets consisting of, and no more than 45% of the issuer's net income after taxes deriving from, securities (excluding government securities). There are also no-action letters in which the SEC Staff concurs with the view that securities in certain money market funds also can be excluded from these calculations.

EMERGING GROWTH COMPANY

A SPAC may be considered an emerging growth company ("EGC") as defined in Section 2(a)(19) of the Securities Act, and, if so, it will remain an EGC until the earlier of (i) the last day of the fiscal year (a) following the fifth anniversary of the completion of the IPO, (b) in which the SPAC has a total annual gross revenue of at least $1.235 billion (adjusted for inflation every five years) or (c) in which the market value of its common equity held by non-affiliates exceeds $700 million as of the prior June 30 (or second fiscal quarter end if not a December 31 fiscal year end company); and (ii) the date on which the SPAC has issued more than $1 billion in non-convertible debt securities during the prior three-year period. If following its initial business combination, the SPAC (newly deSPAC-ed) continues to qualify as an EGC under these rules, the company will continue to benefit from being an EGC.

Marketing and Offering Related Communications Considerations

ROADSHOWS

Under Securities Act Rule 433 any roadshow that is a "written communication" is a free writing prospectus. As discussed above, SPACs are not able to use free writing prospectuses. Under Securities Act Rule 405 a "communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means" does not constitute a written communication. A live, real-time roadshow to a live audience will not be considered a written communication and therefore not a free writing prospectus. This means that for a SPAC IPO:

- Traditional roadshow presentations where the SPAC's management and the underwriters meet in person with prospective investors are acceptable; live telephone conference calls are also permissible;
- A roadshow presentation cannot be recorded; though broadcasts of live, real-time presentations at the time of transmission can be used;
- Roadshow decks may be passed out to meeting attendees but must be collected at the end of the presentation and attendees may not take the slides with them; slides can also be broadcast if they are viewable only during the presentation; and
- Roadshow decks may not be emailed to accounts or transmitted in any way that allows the recipient to keep the deck after the roadshow presentation is over.

SAFE HARBOR ANALYSIS

As a shell company and an ineligible issuer, SPACs may not rely on the following communications safe harbors:

- Research report safe harbors – Securities Act Rules 137, 138 and 139
- Communications more than 30 days before a registration statement is on file – Securities Act Rule 163A

These restrictions expire three years after the SPAC completes its initial business combination.

A SPAC may rely on Securities Act Rule 134 for communications announcing an offering. Communications that comply with Securities Act Rule 134 are deemed not to be a "prospectus," as defined in Section 2(a)(10) of the Securities Act or a free writing prospectus.

Additionally, SPACs may rely on the "access equals delivery" rules under the Securities Act.

TESTING-THE-WATERS COMMUNICATIONS

Under Section 5(d) of the Securities Act, EGCs and persons authorized to act on their behalf (*e.g.*, underwriters) are permitted to participate in oral or written communications with potential investors that are qualified institutional buyers ("QIBs") under Securities Act Rule 144A or institutions that are accredited investors ("IAIs") under Securities Act Rule 501 to determine if those investors may be interested in a potential securities offering. A SPAC may engage in "testing-the-waters" communications.

Nasdaq Considerations

One of the requirements of a Nasdaq Capital Market ("Nasdaq") listing is that securities are held by at least 300 round lot holders (*i.e.*, holders of at least 100 shares of common stock) and that at least 50% of the 300 required round lot holders must hold unrestricted securities with at least $2,500 in value.

To ensure compliance with this listing requirement, Nasdaq typically requires a letter from the managing underwriter of the IPO to the effect that underwriters intend to sell the listed securities such that, following the IPO, there will be at least 300 round lot holders that are unrestricted securities and at least 50% of such round lot holders will hold unrestricted securities with a market value of at least $2,500.

Furthermore, Nasdaq often requests a list of all round lot holders within 15 days after closing of a SPAC's IPO. In order to provide proper evidence to Nasdaq, the SPAC will have to order non-objecting beneficial holder reports and a share range analysis from Broadridge and Mediant after the closing of the IPO.

Nasdaq's position with respect to accepting a share range analysis, without more detailed information, is as follows:

- If the share range analysis shows 300 round lot holders they will not be satisfied, as they will assume that some of the accounts are owned by the same holder.
- If the share range analysis shows 400 or more round lot holders, that is sufficient.
- If the share range analysis shows more than 300 but fewer than 400 round lot holders, that is a judgment call that the examiner will make.

In the event that Nasdaq is not satisfied, it will request that the underwriters provide more information about the investors that bought in the IPO to confirm that 300 different accounts purchased a sufficient number of securities in the IPO. It is unclear that Nasdaq would require this if the information is not available or there are legal or other restrictions on sharing the information.

In counting round lot holders, Nasdaq will not count as separate accounts those for relatives sharing a household. For this reason, the syndicate must coordinate book-building efforts so that they avoid duplicate investors and avoid the risk of not meeting the minimum 300 round lot holders. Underwriters are advised to aim for a 400 holder count in case there are inadvertent duplicate accounts.

Roles of Financial Intermediaries

The underwriter of a SPAC IPO may have various roles in relation to the SPAC once the SPAC has completed its IPO (*e.g.*, capital markets advisor, private placement agent and M&A financial advisor). As an initial matter, every potential new role should be scrutinized for conflicts of interest. This is especially important as the underwriter stands to receive a portion of its underwriting discount (typically 35 basis points to be split among the syndicate members) only if the SPAC completes an initial business combination. As a consequence, the underwriter should ensure that the board of directors of the SPAC and, if appropriate, investors are aware of this conflict of interest as the underwriter engages in any of the roles discussed below.

An underwriter of a SPAC IPO may be asked to assist in various capital markets related activities as the SPAC searches for, and completes, its initial business combination target. These may include: (i) wall crossing accounts to discuss their views on a potential qualifying transaction, (ii) arranging meetings with accounts prior to and during the proxy solicitation process and (iii) assisting the SPAC with the preparation of presentation materials. This role is sometimes described as a "capital markets advisor."

Assisting the SPAC in its communications with investors raises potential issues under the proxy solicitation rules and it is important that the capital markets advisor not be viewed as soliciting a proxy since the underwriter, acting as a capital markets advisor, will not have complied with the various rules and regulations applicable to those soliciting a proxy (including the rules contained in Exchange Act Regulation 14A). As a consequence, the capital markets advisor should consider limiting its activities to ministerial functions. In these ministerial communications the underwriter should consider including language disclosing that it stands to collect its deferred compensation should the SPAC complete its initial business combination.

The underwriter of a SPAC IPO may be asked to act as a placement agent in a PIPE, or to underwrite or arrange debt financing, in each case that may be needed to complete an initial business combination. The underwriter should follow its normal practices for an engagement of this type including, if applicable, entering into a separate engagement letter, inclusive of an indemnification agreement. The engagement letter should include language disclosing that the underwriter stands to collect its deferred compensation should the SPAC complete its initial business combination. The underwriter should also consider including such language in materials sent to investors.

It is common for a former underwriter of a SPAC IPO to bring potential acquisition opportunities to the SPAC and, where the former underwriter either brings the potential acquisition opportunity to the SPAC or has relevant sector expertise, to act as financial advisor to the SPAC. If the former underwriter acts as M&A advisor to the SPAC in its initial business combination, the former underwriter should follow its normal practices for an engagement of this type including, if applicable, entering into a separate engagement letter inclusive of an indemnification agreement. The engagement letter should include language disclosing that the former underwriter stands to collect its deferred compensation should the SPAC complete its initial business combination.

The former underwriter may not want, or the SPAC may not want the former underwriter, to render a fairness opinion with respect to the initial business combination because of the conflict of interest disclosure that would be required in the fairness opinion.

It is less common for a former underwriter of a SPAC IPO to represent the target in an initial business combination. However, depending on the facts and circumstances, the underwriter's fairness committee may be comfortable representing a target and even issuing a fairness opinion (with the appropriate conflict of interest disclosures). This, presumably, would be much more likely where the target is a private company and no public disclosure of the target fairness opinion is required. If the underwriter represents the target in the SPAC's initial business combination, the underwriter should follow its normal practices for an engagement of this type including, if applicable, entering into a separate engagement letter inclusive of an indemnification agreement.

Given that there are more and more well-regarded SPAC sponsors and that SPACs have become a more mainstream investment vehicle, private companies considering an IPO or a direct listing may also want to consider merging into a SPAC. Nonetheless, as discussed throughout this article, not all SPACs are the same, and some structures are better, more transparent and less expensive than others. Further, there are distinct securities laws and regulations to consider with respect to SPACs. As a result, private companies should consider all of the advantages and disadvantages above before deciding that a merger with a SPAC is the best option.

Checklist of Key Questions

- ✓ Has the operating company considered an IPO?
- ✓ Has the operating company undertaken any IPO readiness initiatives?
- ✓ Is the operating company prepared for the diligence to be undertaken by the SPAC in connection with the SPAC initial business combination transaction?
- ✓ Does the operating company have the necessary risk factor, business and management disclosures and the audited annual and reviewed interim financial statements that will be necessary for the SPAC's proxy statement?
- ✓ Has the operating company considered the time and expense required in connection with the negotiation of the initial business combination transaction and the stockholder approval process?
- ✓ Do the operating company stockholders understand the consequences, from a securities law perspective, of being a former shell company (former SPAC) and how these will affect the company's ability to raise capital or to provide liquidity opportunities to stockholders?

Here's the Deal:

- Certain events or transactions are considered "reportable events" under Form 8-K and trigger a company's obligation to publicly disclose their occurrence.
- Form 8-K is a current report filed by a U.S. reporting company with the SEC to disclose such recent material events or transactions.
- As a general rule, the Form 8-K must be filed with the Securities and Exchange Commission (SEC) within four business days after the occurrence of the reportable event.
- It is important for a public company to timely file reports required by the Securities Exchange Act of 1934 (the "Exchange Act"), including Form 8-K, as the failure to do so may result in liability under the antifraud provisions of the federal securities laws. A failure may also impact the company's eligibility to use Form S-3, thus preventing or delaying the company from timely accessing the capital markets.

What's the Deal?

Form 8-K is a report public companies must file with the SEC to announce major corporate events on a current basis. All U.S. "reporting" companies are responsible for filing Forms 8-K to disclose recent material transactions or occurrences. Form 8-K lists the types of "reportable events" that trigger the requirement to file a Form 8-K and prescribes the related information to be included in the report. A reporting company may also voluntarily disclose certain other events on Form 8-K. Subject to certain exceptions described below, a Form 8-K must generally be filed within four business days of the triggering event.

Overview of Reporting Obligations

The occurrence of certain events or transactions specified in the items under Sections 1 to 6 and Section 9 of the form triggers the requirement to file a Form 8-K. Below we describe a number of these reportable events and the related information required to be included in the report, along with the corresponding Section and Item references from Form 8-K.

SECTION 1 – EVENTS RELATED TO THE COMPANY'S BUSINESS AND OPERATIONS

<u>Item 1.01 – Entry Into a Material Definitive Agreement</u>. A Form 8-K is required to be filed if a registrant has entered into a material definitive agreement not made in the ordinary course of the registrant's business or into any amendment of such agreement that is material to the registrant. A "material definitive agreement" is an agreement that provides for obligations that are material to, and enforceable against, the company or rights that are material to the company and enforceable by the company against one or more parties to the agreement. Any agreement that requires board or shareholder approval would likely

be filed under this item. Examples of material definitive agreements include merger agreements, stock purchase agreements, purchase agreements for all or substantially all of a company's assets and agreements to issue securities or to incur debt, such as credit agreements or trust indentures. Non-binding term sheets or letters of intent are not considered "definitive." The company is encouraged (but not required) to attach the material agreement as an exhibit to the Item 1.01 Form 8-K. If the company does not attach the agreement to Form 8-K, it will be required to file the agreement with its next periodic report (*e.g.*, Form 10-K or 10-Q).

If an agreement was not material to the company at the time it was entered into but later becomes material, the company need not file a Form 8-K under this item, unless the agreement is material to the company at the time of an amendment. In any event, the company must file the agreement as an exhibit to the periodic report relating to the reporting period in which the agreement became material if, at any time during that period, the agreement was material to the company.

A company filing a Form 8-K under Item 1.01 must disclose the date on which the agreement was entered into or amended, the identity of the parties and a brief description of the terms and conditions of the agreement or amendment that are material to the company.

<u>Item 1.02 – Termination of a Material Definitive Agreement</u>. If a material definitive agreement is terminated, and, if the termination is material to the company, the company must file a Form 8-K. An agreement that terminates on its stated termination date or as a result of all parties completing their contractual obligations does not trigger a reporting obligation under this item. If a material definitive agreement has an advance notice provision to terminate, and the counterparty delivers notice of termination to the company pursuant to the terms of the agreement, the company must file a Form 8-K.

A company filing a Form 8-K under this item must disclose the date of termination of the agreement, the identity of the parties, a brief description of the terms and conditions of the agreement or amendment that are material to the registrant, the material circumstances surrounding the termination and any material early termination penalties incurred by the company.

<u>Item 1.03 – Bankruptcy or Receivership</u>. The company must file a Form 8-K under Item 1.03 if it becomes the subject of a bankruptcy or receivership court filing. It must disclose the name or other identification of the proceeding, the identity of the court, the date jurisdiction was assumed and the identity of the receiver, fiscal agent or similar officer and the date of his or her appointment. If a court enters an order confirming a plan of reorganization or liquidation for the company, the company must also describe the material features of the plan and file and attach a copy of the confirmed plan as an exhibit to the Form 8-K.

<u>Item 1.04 – Mine Safety – Reporting of Shutdowns and Patterns of Violations</u>. A Form 8-K is required to be filed if a registrant or its subsidiary is an operator of a coal or other mine and has received an imminent danger order issued under section 107(a) of the Federal Mine Safety and Health Act, or a written notice from the Mine Safety and Health Administration that the mine has a pattern of violations of mandatory health or safety standards that could have significantly and substantially contributed to coal or other mine health or safety hazards, or a written notice that the coal or other mine has the potential to have such a pattern. The company must disclose the date of its or its subsidiary's receipt of such order or notice, the category of such order or notice and the name and location of the mine involved.

SECTION 2 – FINANCIAL INFORMATION

<u>Item 2.01 – Completion of Acquisition or Disposition of Assets</u>. A company must file a Form 8-K if it acquires or disposes of a significant amount of assets, other than in the ordinary course of business. An acquisition or disposition of assets is considered significant if (i) the company and its other subsidiaries' equity in the net book value of such assets or the amount paid or received for the assets exceeds 10% of the total assets of the company and its consolidated subsidiaries or (ii) it involves a business that would be considered a significant business or subsidiary under Rule 11-01 of Regulation S-X. The registrant must disclose, among others, the date of completion of the transaction, a brief description of the transaction, the identity of the person from whom the assets were acquired or to whom they were sold and the nature and amount of consideration involved. In addition, the company must file, under Item 9.01, as exhibits to the Form 8-K, financial statements of the business acquired, any pro forma financial statements relating to the assets acquired or disposed of that are required by Regulation S-X and copies of the plans of acquisition or disposition.

<u>Item 2.02 – Results of Operations and Financial Condition</u>. If a company publicly announces or releases material, nonpublic information about its results of operations or financial condition for a completed quarterly or annual fiscal period, it must provide a Form 8-K to the SEC. The Form 8-K must disclose the date of the announcement or the release, briefly identify the same and include the text of the announcement or release as an exhibit to the Form 8-K. Companies usually attach an earnings press release as an exhibit to the Form 8-K. The materials included under Item 2.02 are considered "furnished" rather than "filed" unless the company specifically states that the information is to be considered "filed." This distinction is important because Section 18 of the Exchange Act imposes liability for material misstatements or omissions contained in reports and other information "filed" with the SEC. By contrast, reports and other information that are "furnished" to the SEC (to the extent expressly permitted under applicable SEC rules) do not attract liability under Section 18. Note, however, that other liability provisions under the Exchange Act may apply that are not dependent on the filing of documents with the SEC, but may otherwise be triggered by disclosure made by the company to the public. See, for example, the antifraud provisions under Section 10(b) of the Exchange Act and Rule 10b-5.

<u>Item 2.03 – Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement</u>. A company that becomes obligated on a direct financial obligation that is material to the company must file a Form 8-K under this item. A "direct financial obligation" includes a long-term debt obligation, finance lease obligation or operating lease obligation (each pursuant to the applicable FASB ASC accounting standard) and a short-term debt obligation that arises other than in the ordinary course of business. A company must report the date on which it becomes obligated on the direct financial obligation, a brief description of the transaction involved, the amount of the obligation, including the payment terms and, if applicable, the material terms for accelerating or increasing the obligation and other terms of the transaction agreement that are material to the company. The company must also file a Form 8-K under this item if it incurs a material obligation arising from an off-balance sheet arrangement. For this, it must also disclose the date on which it becomes directly or contingently liable, the material terms of the obligation and the maximum potential amount of future payments that it may be required to make. Note that for this item, a company has no obligation to disclose information until the company enters into an agreement that is enforceable against it.

Item 2.04 – Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement. A company must file a Form 8-K if a triggering event causes the increase or acceleration of a financial obligation and if the consequences of such triggering event are material to the company. A "triggering event" under this item includes an event of default, event of acceleration or other similar event. Hence, if the company defaults on its loan payment obligations and that default constitutes an event of default under the loan agreement or otherwise triggers the acceleration or increase of a financial obligation that is material to the company, then disclosure under this item would be needed. The company must report the date and description of the triggering agreement, a brief description of the underlying agreement or transaction, the increase in the amount of the obligation, terms of payment and acceleration and other material obligations that may arise.

Item 2.05 – Costs Associated With Exit or Disposal Activities. This item requires a company to disclose material write-offs or restructuring charges. In the Form 8-K, the company must include an estimate of the dollar amounts of (i) each major cost, (ii) total costs and (iii) cash expenditures (the estimate portion of the disclosure can be delayed until four business days after estimates are known).

Item 2.06 – Material Impairments. A company must file a Form 8-K if it takes a material impairment charge to one or more of its assets, including impairments of securities or goodwill. An impairment may occur when the company significantly lowers its estimate of the value of certain assets. The company must report, among other things, the date its board, board committee or officers concluded that the material charge is required and the surrounding facts and circumstances leading to such conclusion, a description of the impaired assets and the company's estimates of the amount or range of amounts of the impairment charge. If the company determines that it is required to take a material impairment charge near the end of a fiscal quarter or year, the company can disclose this information in the corresponding Form 10-Q or 10-K instead of filing a Form 8-K.

SECTION 3 – SECURITIES AND TRADING MARKETS

Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing. A company must file a Form 8-K under this item if (a) the company receives a notice from a securities exchange on which it is listed that it is no longer in compliance with the rules of such exchange, (b) the company notifies the securities exchange that it is aware of any material noncompliance with the continued listing rules of the exchange, (c) the securities exchange issues a public reprimand letter to the effect that the company has violated a rule for continued listing or (d) the company's board, board committee or officers voluntarily withdraw or terminate its listing. A company that receives a notice of delisting would file two Forms 8-K: when it receives the first notice and again once the delisting is effective. No filing is required, however, if the delisting is the result of a conversion or redemption of a security. Under this item, the filing date is calculated from receipt of the notice.

Item 3.02 – Unregistered Sales of Equity Securities. A company is required to file a Form 8-K if its private sales of equity securities exceed 1% of the company's outstanding shares of that class. For a smaller reporting company, the reporting duty is triggered when the sales exceed 5% of the company's outstanding shares in the class of securities sold. The company must disclose the date of sale, the title and amount of securities sold, the aggregate offering price and commission for securities that were sold for cash, the nature and amount of consideration for securities sold other than cash, the rule or law upon

which the company claims an exemption from registration, the facts relied upon for the exemption and the terms of conversion or exercise for securities that are convertible or exchangeable into equity.

Item 3.03 – Material Modification to Rights of Security Holders. Companies must disclose any material changes to the instruments that define the rights of holders of any class of registered securities of the company (*e.g.*, the company's governing documents) or any material limitations on the rights of such holders that result from the issuance or modification of another class of securities. The company must disclose the date of the modification, the title of the class securities involved and a brief description of the effect of such modification on the rights of holders of such securities. Note that working capital restrictions and other limitations upon the payment of dividends must be reported under this item. Other modifications that may be captured by this item include amendments, changes or additions to preferred stock preferences or the issuance of senior securities affecting junior securities.

SECTION 4 – MATTERS RELATED TO ACCOUNTANTS AND FINANCIAL STATEMENTS

Item 4.01 – Changes in Registrant's Certifying Accountant. A company must file a Form 8-K if (a) its auditors resign, are dismissed or decline reappointment or (b) it hires a new auditor. Departure of the auditor and the company's engagement of new auditors are separate reportable events and may require separate Forms 8-K.

When auditors leave, the company must include in its report whether the auditors were dismissed or resigned, whether their departure was approved by the board of directors, whether the auditors issued an adverse or qualified opinion on the company's financial statements in the past two years and whether the auditors had disagreements with any company personnel responsible for preparing the financial statements.

When the company engages new auditors before it files the Form 8-K related to the former auditors' departure, the Form 8-K must also include the name of the new auditors and their hire date and whether the company previously consulted with the new auditors before their engagement. Otherwise, that information must be included in a separate Form 8-K. The obligation to file a Form 8-K under this item cannot be avoided by reporting it in a Form 10-K or 10-Q.

Item 4.02 – Non-reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review. If management or an auditor concludes that the company's previously issued financial statements should not be relied upon, or the company receives notice from its independent accountant that the independent accountant is withdrawing a previously issued audit report or the independent accountant informs the company that it may not rely on a previously issued audit report, then a Form 8-K under this item must be filed. The obligation to file a Form 8-K under this item cannot be avoided by reporting it in a Form 10-K or 10-Q.

SECTION 5 – CORPORATE GOVERNANCE AND MANAGEMENT

Item 5.01 – Changes in Control of Registrant. If the company's board of directors, board committee or authorized officers become aware that a change in control of the company has occurred, the company must file a Form 8-K identifying who has acquired control, the date and description of the transaction that resulted in the change in control, the amount of consideration used, the percentage of voting securities of the company beneficially owned by the persons who acquired control and any arrangements between the old and new control groups regarding the election of directors or other matters.

Item 5.02 – Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers. An obligation to file a report under this item may arise from any of the following occurrences:

- A director's resignation or refusal to stand for reelection due to a disagreement.
- The election or appointment of new directors (other than at an annual or special meeting of shareholders).
- The departure of any director for any reason.
- The retirement, resignation or termination (including demotion to a non-executive position) of a company's principal executive officer, president, principal financial or accounting officer, principal operating officer or person performing a similar function to any such officers ("Senior Executive Officers").
- The appointment of any Senior Executive Officer and the entry into (or amendment of) a compensatory arrangement with a principal executive officer, principal financial officer or named executive officer.

A company is not required to file a Form 8-K if it decides not to nominate a director for reelection at its annual meeting. If, however, the director receives notice from the company that it does not intend to nominate him or her for reelection, then resigns from his or her position as director, reporting requirements under this item will be triggered. Similarly, if the director tells the company that he or she refuses to stand for reelection, a Form 8-K is required because the director has communicated a "refusal to stand for reelection."

Departure, arrival and election of board members and Senior Executive Officers from the company's subsidiaries do not trigger the reporting requirement under this item.

Item 5.03 – Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year. Under this item, companies with securities registered under Section 12 of the Exchange Act are generally required to disclose any amendment to their articles of incorporation or bylaws or changes in its fiscal year, unless the company previously disclosed the amendment or fiscal year change in a proxy statement or an information statement. Companies that only issue debt securities are typically not required to comply with this item. A Form 8-K is not required when the company restates its articles without any substantive amendments; however, it is recommended that companies refile their complete articles of incorporation, if restated, with their next periodic report for ease of reference by investors.

Item 5.04 – Temporary Suspension of Trading under Registrant's Employee Benefit Plans. A company must file a Form 8-K if there is a prohibition on trading its securities under one of its employee benefit plans. The Form 8-K must be filed if the company receives a notice of the blackout period from the administrator of the employee benefit plan, or if no such notice is received, the company notifies its directors and officers of such blackout period. The company must report, among other things, the reason for, and the length of, the blackout period, the securities subject to and the transactions suspended during the blackout period and contact information for a designated person to respond to questions.

Item 5.05 – Amendments to the Registrant's Code of Ethics or Waiver of a Provision of the Code of Ethics. Companies are generally required to report any amendments to their codes of ethics that apply to the

Senior Executive Officers. In addition, a company must file a Form 8-K if it waives any provision of its code of ethics for a Senior Executive Officer. The company does not need to file a Form 8-K under this item if the company stated in its most recent annual report or Form 10-K that it would disclose any such amendment or waiver on its website and provided the website address. Also, note that the company need not disclose technical, administrative or other non-substantive amendments to its code of ethics.

Item 5.06 – Change in Shell Company Status. If a shell company completes a transaction that results in it no longer being a shell company, the company must file a Form 8-K describing the material terms of the transaction. Companies created solely for the purpose of completing business combinations, such as SPACs, are not required to comply with this item.

Item 5.07 – Submission of Matters to a Vote of Security Holders. Companies must report the results of shareholder votes in director elections and all other matters put to a vote within four business days of the end of an annual or special meeting. If the final voting results are not available by the time the Form 8-K is due, the company must file preliminary results, then amend the original Form 8-K within four days after the final results have been determined.

Item 5.08 – Shareholder Director Nominations. If the company did not hold an annual meeting during the previous year, or if the date of this year's annual meeting has been changed by more than 30 calendar days from the date of the previous year's meeting, then the company will be required to disclose the date by which a nominating shareholder must submit notice on Schedule 14N of director nominations.

SECTION 6 – ASSET-BACKED SECURITIES

A company that has issued asset-backed securities must report the following events related to those securities:

Item 6.01 – ABS Informational and Computational Material. (As defined in Item 1101 of Regulation AB).

Item 6.02 – Change of Servicer or Trustee.

Item 6.03 – Change in Credit Enhancement or Other External Support.

Item 6.04 – Failure To Make a Required Distribution.

Item 6.05 – Securities Act Updating Disclosure. Companies must disclose updates to the description of the asset pool in an offering of asset-backed securities.

Item 6.06 – Static Pool.

SECTION 7 – REGULATION FD

Item 7.01 – Regulation FD Disclosure. Companies may submit a Form 8-K under this item in order to comply with the public disclosure requirement of Regulation FD. Information provided under this item is considered to be furnished rather than filed, as discussed in Item 2.02 above.

SECTION 8 – OTHER EVENTS

Item 8.01 – Other Events. If a company deems an event to be of importance to securityholders, but the event does not fall under any of the items described above, the company may disclose the event under this item. This item is commonly used to report new products, press releases and other miscellaneous non-categorizable events. Companies may also use an Item 8.01 filing to update its shelf registration with more current information. Unlike most Form 8-K filings, there is no requirement that an Item 8.01 Form 8-K be filed within four business days of the triggering event (see below for a further discussion of the relevant timing requirements).

SECTION 9 – FINANCIAL STATEMENTS AND EXHIBITS

Item 9.01 – Financial Statements and Exhibits. Companies use this item to file certain financial statements and to list exhibits that were appended to the Form 8-K, such as the material definitive agreements discussed in Item 1.01.

COMPLETING FORM 8-K

Events will commonly be reportable under more than one item, but, except in the case of departing and newly engaged auditors (see Item 4.01), companies may include multiple items in a single Form 8-K, and any exhibits may be cross-referenced in the same Form 8-K. Common instances when this is necessary include:

- Unregistered offerings of securities (Items 1.01 and 3.02);
- Acquisitions (Items 1.01 and 2.01);
- Changes to securities (Items 3.03 and 5.03);
- Appointments of officers (Items 1.01 and 5.02(c)); and
- Additions of directors (Items 5.02(d) and 5.03).

Similarly, the cover page of the Form 8-K allows the company to "check" one or more boxes on the front cover of Form 8-K to indicate that the Form 8-K is being used to satisfy other specified filing requirements.

If the company checks the first box, it is indicating that the Form 8-K is being used to file "written communications pursuant to Rule 425 under the Securities Act." This rule governs communications made with respect to a business combination (*e.g.*, a merger of two public companies). For example, if Company A agrees to purchase the common stock of Company B with shares of its own (Company A) stock, then any communication it transmits (a letter to employee shareholders of Company B, for instance) would be considered a prospectus (under Rule 165 under the Securities Act) and must be filed with the SEC. Form 8-K may be used for this purpose. Company A would file the shareholder letter as an exhibit to a Form 8-K and check the appropriate box on the cover.

The second box indicates that the Form 8-K contains "soliciting material pursuant to Rule 14a-12 under the Exchange Act." Under the proxy rules, a person may not solicit proxies from a shareholder without providing a preliminary or definitive proxy statement prior to or concurrently with the solicitation. Rule 14a-12 is one of the most prevalent exceptions to these rules. Rule 14a-12 provides that solicitations are allowed as long as any written solicitation contains specified information and is filed with the SEC on the first day it is used. Form 8-K can be used to satisfy this requirement as well.

The third or fourth boxes would be checked if the Form 8-K contains "pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act" or "pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act." Under certain circumstances, a tender offeror may communicate with offerees prior to the commencement of a tender offer.

FILING REQUIREMENTS

Subject to certain exceptions described below, a Form 8-K must generally be filed within four business days of the triggering event. Exceptions include:

- Regulation FD filings must be (*a*) simultaneous with the release of the material that is the subject of the filing (if such material is intentionally released to the public) or (*b*) the next trading day (if the release was unintentional);
- Voluntary disclosures (Item 8.01) have no deadline;
- Filing of earnings press releases (Item 2.02(b)) must be completed before any associated analyst conference call;
- It is permissible to delay the filing of a Form 8-K related to the announcement of new officers until another public announcement of the appointment (*e.g.*, press release, trade conference, etc.);
- The filing of a Form 8-K related to an issuer's receipt of an auditor's restatement letter (Item 4.02) must be completed within two business days; and
- The financial statements of an acquired business (Item 9.01) must be filed no later than 71 calendar days after the date that the initial report on Form 8-K must be filed (four business days plus 71 calendar days).

Note also that if the triggering event occurs on a Saturday, Sunday or holiday on which the SEC is not open for business, then the four-business-day period shall begin to run on, and include, the first business day thereafter.

PENALTIES FOR NON-COMPLIANCE AND IMPACT ON SHELF ELIGIBILITY

The penalties for failing to comply with these requirements can be severe and include the company's loss of the right to use Form S-3 for both primary and secondary offerings (however, failure to file within the required time period with respect to events subject to Items 1.01, 1.02, 2.03-2.06, 4.02(a) or 5.20(e) will not affect an issuer's right to use Form S-3).

No failure to file under the following Items shall be deemed a violation of Section 10 of the Exchange Act and Rule 10b-5: 1.01, 1.02, 2.03-2.06, 4.02(a), 5.02(e) or 6.03.

In addition, SEC guidance makes clear that the failure to properly file a Form 8-K may be considered prima facie evidence of a lack of sufficient disclosure controls under The Sarbanes-Oxley Act of 2002. Nevertheless, a company's Senior Executive Officers are not required to provide a certification with respect to the Form 8-K's accuracy, even if the Form includes financial statements.

Checklist of Key Questions

- ✓ Has the company experienced a material event or transaction that is a reportable event under Form 8-K, thus triggering public disclosure?
- ✓ Have the material terms or circumstances of the agreement, transaction or occurrence been set forth fully and accurately as required by Form 8-K?
- ✓ Is the company "filing" or "furnishing" the information under the relevant item under Form 8-K?
- ✓ Are all required exhibits attached? Are there other exhibits that will enhance the quality of the disclosures?
- ✓ What is the deadline for filing the Form 8-K? Is the information required to be reported within the usual four-business-day period or does a different filing deadline apply?
- ✓ Has the company provided enough information about the occurrence to allow shareholders to make an informed decision about their investment?
- ✓ Can the reporting obligation be satisfied by disclosing the necessary information in the company's next Form 10-Q or 10-K?
- ✓ Is there any confidential information that ought to be redacted prior to filing?

Rule 10b-18

Here's the Deal:

- Rule 10b-18 provides a non-exclusive safe harbor for an issuer from liability under certain market manipulation rules and Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in connection with stock repurchases.
- This safe harbor is available for repurchases of an issuer's securities on any given day.
- To fall within the safe harbor, the issuer's repurchases must satisfy, daily, each of the rule's manner, timing, price and volume conditions. Failure to meet any one of these conditions disqualify all of the issuer's repurchases from the safe harbor for that day.
- Due to the increased scrutiny surrounding stock repurchase programs, issuers seeking to repurchase their common stock should have a heightened awareness of the regulatory, legal and other considerations discussed here.

What's the Deal?

Rule 10b-18 provides an issuer (and its "affiliated purchasers") with a non-exclusive safe harbor from liability under certain market manipulation rules (*i.e.*, Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act) when repurchases of the issuer's common stock are made in accordance with the rule's manner, timing, price and volume conditions. The safe harbor is available for purchases of the issuer's stock on any given day. To come within the safe harbor, the issuer's repurchases must satisfy, daily, each of the rule's four conditions. Failure to meet any of the four conditions will disqualify all of the issuer's repurchases from the safe harbor for that day.

Purpose and Benefits of a Stock Repurchase Program

An issuer may want to engage in stock repurchases for a variety of reasons, including to send a signal to the market that the stock is undervalued and a good investment, and to reduce its cost of capital.

There are several potential benefits associated with stock repurchase programs depending on the issuer's circumstances. These may include the following:

- The availability of a non-exclusive safe harbor from liability for manipulation of the issuer's stock price (if Rule 10b-18's conditions are met);
- Greater certainty to the issuer and affiliated purchasers in planning purchases of the issuer's common stock;
- Increased liquidity, which should benefit shareholders;
- Minimizing dilution following a stock acquisition;
- A tax-efficient alternative to dividends as a way to return money to shareholders; and

- Shares repurchased by an issuer are either canceled or kept as treasury stock, which then reduces the number of the issuer's shares outstanding, which may be beneficial to the issuer's earnings per share calculations.

Conditions for Repurchases Under Rule 10b-18

Rule 10b-18's non-exclusive safe harbor is available only when the repurchases of the issuer's common stock in the market are made in accordance with the following conditions:

- Manner of purchase condition: requires an issuer to use a single broker or dealer per day to bid for or purchase its common stock;
- Timing condition: restricts the periods during which an issuer may bid for or purchase its common stock;
- Price condition: specifies the highest price an issuer may bid or pay for its common stock; and
- Volume condition: limits the amount of common stock an issuer may repurchase in the market in a single day.

Failure to meet any one of the rule's conditions will disqualify the issuer's purchases for that day from the safe harbor.

MANNER OF PURCHASE CONDITION

On a single day, the purchases and any bids of the issuer or its affiliated purchasers must be made through one broker or dealer. However, this restriction does not bar the issuer or its affiliated purchasers from making purchases if they are deemed not solicited by or on behalf of the issuer, such as purchases not solicited from additional brokers or dealers or when a shareholder approaches the issuer to have it buy shares. An issuer must evaluate whether a transaction is "solicited" based on the facts and circumstances in each case. Additionally, on a daily basis, the issuer may use a different broker or dealer to execute purchases. Furthermore, an issuer may use a different broker or dealer during an after-hours trading session from the one used during regular hours.

An issuer that directly accesses an electronic communication network ("ECN") or an alternative trading system ("ATS") to purchase common stock will be considered to be using one broker or dealer and cannot purchase its common stock through a non-ECN or non-ATS broker or dealer on the same day.

The purpose of this condition is to avoid creating the false appearance of widespread purchasing interest and trading activity in the issuer's common stock through the use of many brokers or dealers on any given trading day.

TIMING CONDITION

A purchase by the issuer may not be the opening transaction reported in the consolidated system, the principal market or the market where the purchase is affected. A consolidated system is a transaction or quotation reporting system that collects and publicly disseminates on a current and continuous basis, transaction or quotation information in common equity securities pursuant to an effective transaction reporting plan or an effective national market system plan.

Additionally, the purchase may also not be effected during the ten minutes before the scheduled close of the primary trading session in the principal market for the security or during the last ten minutes before the scheduled close of the primary trading session in the market where the purchase is effected for a security that has an average daily trading volume (ADTV) of $1 million or more and a public float of $150 million or more. The ADTV is the volume reported for the security during the four calendar weeks preceding the week in which the Rule 10b-18 purchase is to be effected. For all other securities, purchases may not be effected during the 30 minutes before the scheduled close of the primary trading session in the principal market for the security or the 30 minutes before the scheduled close of the primary trading session in the market where the purchase is affected.

An issuer purchase may be effected following the close of the primary trading session in the principal market until the termination of the period in which the last sale prices are reported in the consolidated system if: (i) the purchase is effected at a price that does not exceed the lower of the closing price of the primary trading session in the principal market for the security and any lower bids or sales prices subsequently reported in the consolidated system, (ii) all of the other Rule 10b-18 requirements are met and (iii) the issuer's Rule 10b-18 purchase is not the opening transaction of the session following the close of the primary trading session.

The purpose of this condition is to prevent the issuer from establishing the opening or closing price of the stock, both of which are considered to guide the direction of trading.

PRICE CONDITION

During trading hours, if the security is reported in the consolidated system, displayed and disseminated on any national securities exchange or quoted on any inter-dealer quotation system that displays at least two price quotations, issuer purchases must be made at a price not exceeding the highest independent bid or last transaction price, whichever is higher. For all other securities, an issuer will need to look at the highest independent bid obtained from three independent dealers.

For after-hours trading, stock repurchase prices must not exceed the lower of the closing price of the primary trading session in the principal market for the security and any lower bids or sales prices subsequently reported in the consolidated system by other markets. The issuer is permitted to repurchase until the termination of the period in which last sale prices are reported in the consolidated system.

The purpose of the price condition is to prevent an issuer from propping up its stock price through the repurchases or from supporting the price at a level that would not otherwise be maintained by independent market forces.

VOLUME CONDITION

The purchases on a particular day may not exceed 25% of the ADTV in the preceding four weeks. "Block" transactions are included in determining the 25% limit and include trades of not less than $50,000 with a volume of not less than 5,000 shares if the trade value is less than $200,000, but excludes any securities the issuer knows or has reason to know were accumulated by a broker-dealer, acting as a principal, for the purpose of resale to the issuer. Alternatively, the issuer may make one "block" purchase per week and not be subject to the 25% limit, provided the "block" purchase is the only Rule 10b-18 purchase made on that same day. Rule 10b-18's volume calculation carries over from the regular trading session to after-hours trading sessions.

The purpose of the volume condition is to prevent the issuer from dominating the market by purchasing a large amount of its common stock relative to other market transactions.

SEVERE MARKET DOWNTURNS

The Rule 10b-18 safe harbor conditions are modified following a market-wide trading suspension. The volume condition is modified so that the issuer may purchase up to 100% of the security's ADTV. Additionally, the time of purchase condition does not apply (a) from the reopening of trading until the scheduled close of trading on the day that the market-wide trading suspension is imposed or (b) at the opening of trading on the next trading day until the scheduled close of the trading day, if a market-wide trading suspension was in effect at the close of trading on the preceding day.

Establishing a Stock Repurchase Program

When establishing a stock repurchase program an issuer should consider (i) the impact on the issuer's cash position and capital needs for its continuing operations; (ii) alternative uses for the cash that will be used for repurchases, including repayment of outstanding indebtedness; and (iii) the possible effect on earnings per share and book value per share. The issuer should consult with its accountants regarding the issuer's capital position prior to implementing a stock repurchase program. Additionally, prior to implementing a stock repurchase program, the issuer should conduct a review of its charter, bylaws and the agreements to which it is a party, or by which it is bound, to determine whether there are any restrictions on, or impediments to, the issuer's use of funds to acquire its own securities. Specifically, the issuer's loan agreements and security documents should be reviewed for any such limitations. These restrictions may be direct limitations on repurchases or indirect limitations in the form of financial ratios and covenants.

STATE LAW RESTRICTIONS

Certain provisions of the Delaware General Corporation Law (DGCL) contain restrictions regarding legally available funds that apply to repurchases of shares of capital stock. Under DGCL Section 160, a Delaware corporation cannot purchase shares of its capital stock when the purchase "would cause any impairment of the capital of the corporation." The issuer should consult with its outside counsel regarding any applicable state law restrictions prior to implementing a stock repurchase program.

Additionally, the California Corporations Code requires that a California corporation must follow certain requirements prior to engaging in a distribution which includes issuer repurchases. Accordingly, an issuer repurchase may only be made if either (a) the amount of retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of (i) the amount of the proposed distribution plus (ii) the preferential dividends arrears amount; or (b) immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

BOARD APPROVAL

Any stock repurchase program should be authorized and approved by the issuer's board of directors. As part of this authorization, the board should document the purpose of the share repurchase. It is important that the board concludes that the repurchase program is desirable and in the issuer's and its shareholders' best interests. When approving a repurchase program, it is advisable that the board

establishes a record of discharging its fiduciary duty. The record should include a current review, in consultation with the issuer's accountants, of the issuer's capital position and a thorough discussion of the purpose of the program.

REPORTING REQUIREMENTS

Regulation S-K and Forms 10-Q, 10-K and 20-F (for foreign private issuers) require periodic disclosure for all issuer repurchases of equity securities. This disclosure is required regardless of whether the repurchase is effected in reliance on the Rule 10b-18 safe harbor. An issuer must disclose in tabular form (a) the total number of shares, by month, repurchased during the past quarter; (b) the average price paid per share; (c) the number of shares that were purchased as part of a publicly announced repurchase plan; and (d) the maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs. For publicly announced repurchase plans, the issuer is also required to disclose (by footnotes to the table) the following information: (a) the announcement date; (b) the share or dollar amount approved; (c) the expiration date (if any) of the plans or programs; (d) each plan or program that has expired during the period covered by the table; and (e) each plan or program that the issuer has determined to terminate prior to expiration or under which the issuer does not intend to make further purchases. Additionally, the issuer should consider discussing any repurchase program under the "Liquidity and Capital Resources" section of the MD&A if material. The issuer should also consider whether disclosure of significant repurchases is required in the notes to its financial statements.

PUBLIC ANNOUNCEMENTS

Issuers should publicly announce the adoption of a stock repurchase program before it is implemented. However, an announcement should not be made unless the issuer actually intends to repurchase shares because any termination of the repurchase program without purchases could be deemed manipulative in the absence of a sound business reason.

The specifics of the public announcement depend on the circumstances, but the issuer should include the following:

- The reason for the repurchase;
- The approximate maximum number or aggregate dollar amount of shares to be repurchased;
- The method of purchase to be used;
- Any significant corporate developments which have not been previously disclosed;
- The impact of the repurchase program on the remaining outstanding shares;
- Any arrangement, contractual or otherwise, with any person for the purchase of the shares;
- Whether the purchases are to be made subject to restrictions relating to volume, price and timing in an effort to minimize the impact of the purchases upon the market for the shares; and
- The duration of the program.

The announcement of the stock repurchase program should be made on Form 8-K with any press release included as an exhibit for purposes of Regulation FD. The issuer should also be mindful that any material changes to its stock repurchase program (including program size) should be publicly disclosed as well.

REPURCHASE STRUCTURES

Issuers have significant flexibility with respect to choosing a particular repurchase structure ranging from open market repurchases to repurchases that are subject to tender offer rules. An issuer may structure its repurchase as an accelerated stock repurchase (ASR). An ASR may result in faster execution and more price certainty; however, ASR repurchases do not benefit from the Rule 10b-18 safe harbor. An ASR is a privately negotiated transaction, usually documented as a forward contract, in which a repurchase agent agrees to sell a predefined amount of stock to an issuer at a price per share based on the volume weighted average price during the specified period. A repurchase agent acts as the seller of the issuer's shares in an ASR and the issuer acts as the purchaser buying back its own shares. ASRs provide numerous benefits, including transaction efficiency, an immediate share count reduction, certainty as to the timing and quantity of the repurchase and possible accounting advantages. Notwithstanding these benefits, ASRs have been the subject of some criticisms. As a result, an issuer should consider its alternatives carefully.

At the beginning of the ASR, the issuer pays a predefined dollar amount to the repurchase agent for a specified number of securities. The repurchase agent generally borrows securities from stock lenders and delivers those securities to the issuer. Over time, the repurchase agent will buy securities in the market to cover its borrow and has the option to complete the ASR at any time within a pre-agreed period. The purchase period will have a fixed starting and end point, though the repurchase agent will have the right, upon notice to the issuer, to shorten the period. An average price is determined for the purchase period, which is typically based on the Rule 10b-18 pricing condition minus an agreed discount or price adjustment. At the ASR's final settlement, the total number of securities purchased by the issuer generally equals the ASR dollar size divided by the discounted average price. If the repurchase agent did not deliver a sufficient number of securities at inception, it must deliver incremental securities to the issuer at the end of the ASR. Conversely, if the repurchase agent delivered too many securities, the issuer must settle with the repurchase agent in cash or stock on the settlement date.

Purchase Activity Covered by Rule 10b-18

The Rule 10b-18 safe harbor only applies to purchases by an issuer of its common stock (or an equivalent interest, such as a unit of beneficial interest in a trust or limited partnership or a depository share). It does not apply to any other type of security, such as purchases of preferred stock, warrants, convertible debt securities, options or security future products. However, many issuers analogize to the conditions of Rule 10b-18 in connection with repurchases of other equity or equity-linked securities.

Generally, open market purchases by an issuer of its common stock are covered by the safe harbor. However, certain types of purchases of common stock are not covered by Rule 10b-18, due to the greater potential risk of manipulation of the price of the stock by the issuer. Such transactions include: (i) purchases effected by or for an employee plan by an agent independent of the issuer; (ii) purchases of fractional interests; (iii) certain purchases made pursuant to a merger, acquisition or similar transactions involving a recapitalization (subject to certain exceptions); and (iv) purchases made pursuant to a tender offer governed by the Williams Act.

Purchases by an affiliate will be attributable to the issuer under Rule 10b-18 where, directly or indirectly, (a) the affiliate controls the issuer's Rule 10b-18 purchases, (b) the issuer controls the affiliate's

Rule 10b-18 purchases or (c) the Rule 10b-18 purchases by the affiliate and the issuer are under common control. Purchases by persons acting in concert with the issuer for the purposes of acquiring the issuer's common stock will also be attributed to the issuer. If Rule 10b-18 purchases are effected by or on behalf of more than one affiliated purchaser (or the issuer and one or more of its affiliates) on a single day, the issuer and all affiliated purchasers must use the same broker or dealer.

Interaction Between Rule 10b-18 and Other Federal Securities Laws

Rule 10b-18 provides an issuer a safe harbor from liability for manipulation in connection with stock repurchases in the open market; however, it does not provide protection from other federal securities laws, such as insider trading and antifraud provisions. An issuer making purchases pursuant to a stock repurchase program must still comply with other regulatory reporting requirements.

RULE 10b-5

An issuer can address concerns regarding Rule 10b-5 liability by structuring its stock repurchase program to comply with the Rule 10b5-1 safe harbor. Compliance with the safe harbor under Rule 10b5-1 generally requires that the issuer, before becoming aware of any material nonpublic information ("MNPI") do one of the following: (i) enter into a binding contract to purchase the securities; (ii) instruct another person to purchase the securities for the issuer's account; or (iii) adopt a written plan for purchasing or selling the securities and conform its stock repurchases to the requirements of a Rule 10b5-1 plan. For a Rule 10b-18 repurchase program to meet the requirements of the safe harbor under Rule 10b5-1, the program must contain one of the following elements: (i) it must specify the amount, price and date of the transactions(s); (ii) it must include a written formula, algorithm or computer program for determining amounts, prices and dates for the transaction(s); or (iii) it must not permit the issuer to exercise any subsequent influence over how, when or whether to make purchases or sales (and any other person exercising such influence under the stock repurchase program must not be aware of MNPI when doing so). Furthermore, the repurchase program must be entered into in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. The issuer must implement reasonable policies and procedures to ensure that individuals making investment decisions on its behalf would not violate the laws prohibiting trading on the basis of MNPI.

The Securities and Exchange Commission (SEC) recently announced that it settled charges against an issuer relating to its alleged failure to establish reasonable controls to ensure that the issuer did not conduct a buyback while in possession of MNPI. While the issuer named in the SEC's enforcement action had authorization for the stock repurchase from its board of directors, this was given on the condition that the company is not in possession of MNPI. In its press release, the SEC noted that the issuer in question did not take reasonable steps to ensure that its stock repurchase complied with such policy, which highlights the importance of establishing effective checks and policies for issuers using stock repurchase programs.

REGULATION M

Under Rule 102 of Regulation M, with certain exceptions, the issuer cannot repurchase its common stock during certain restricted periods if at the same time the issuer or an affiliate is engaged in a "distribution" of the same class of equity securities or securities convertible into the same class of equity securities. Regulation M requires repurchase activity to be discontinued one business day prior to the determination of the offering price for the securities in distribution until the issuer's completion of its participation in distribution. The term "distribution" in this context covers more than conventional public offerings and includes any offering which is distinguished from any ordinary trading transaction by the magnitude of the offering and the presence of special selling efforts and methods. This definition may include certain offerings in connection with acquisitions or exchange offers. Such a distribution might also take place if a major stockholder of the issuer that is an affiliate was engaged in significant sales of the issuer's stock.

An issuer should assume that its officers, directors and controlling shareholders will be deemed to be "insiders;" that the rules as to insiders will apply to purchases as well as sales; that the rules generally require disclosure of material facts concerning the issuer or affecting the market in securities of the issuer not generally known to the public; and that the disclosure or use of nonpublic information may violate a fiduciary duty owed to the issuer or stockholders to whom it is not disclosed. As a result, an issuer may want to consider:

- Avoiding purchases of stock at any time when an insider is selling equity securities, and insiders should avoid selling the issuer's stock, when the issuer is purchasing its own stock.
- Encouraging its executive officers, directors and other insiders not to go into the market and purchase or sell, on their own behalf, the issuer's common stock during the course of any repurchase program, unless they advise a designated officer and secure confirmation that such action will not violate any applicable securities or other laws or fiduciary obligations to the issuer or its stockholders.

NEGOTIATING REPURCHASE AGREEMENTS

Repurchase agreements that document traditional open market purchases are typically short form agreements. Most repurchase agents have a form of repurchase agreement that will serve as a starting point. The form repurchase agreement will incorporate the applicable Rule 10b-18 provisions in setting out the mechanics of the repurchase. The repurchase agreement appoints the repurchase agent and authorizes it to make open market purchases on the issuer's behalf in accordance with the terms and conditions set forth in the agreement. As part of the agreement, the repurchase agent agrees to use commercially reasonable efforts to purchase the issuer's outstanding shares and comply with the pricing, timing and volume guidelines that are provided to the repurchase agent by the issuer. The repurchase agent typically disclaims responsibility for complying with Rule 10b-18(b) (4) (volume of purchases) to the extent that the issuer or any affiliated purchaser of the issuer has separately purchased securities without informing the repurchase agent. The agreement will include customary issuer representations and warranties. Unlike the repurchase agreement for traditional open market repurchases, the documentation for ASRs has not become fully standardized. An issuer typically pre-negotiates forms of ASR documents with members of its lending syndicate. Typically, either a master confirmation or agreement is used with supplemental confirmations containing economic terms for individual transactions or stand-alone long-form confirmations that incorporate or reference an International Swaps and Derivatives Association (ISDA) Master Agreement are used. The master confirmation structure is more prevalent as it allows for multiple transactions to be consummated using the same legal terms.

COVID-19 Pandemic

As a result of the COVID-19 pandemic, the U.S. stock markets have experienced heightened volatility. This volatility may generate incentives for issuers to repurchase their common stock at lower prices in comparison to pre-pandemic trading levels. However, these incentives must be balanced in light of the heightened scrutiny surrounding issuer repurchase programs.

One specific regulatory concern relating to the pandemic for issuers contemplating a stock repurchase program is the Coronavirus Economic Stabilization Act of 2020 under the Coronavirus Aid, Relief, and Economic Stability Act (the "CARES Act"), which was enacted on March 27, 2020, to address the impact of the COVID-19 outbreak in the United States. Under the CARES Act, the federal and state governments offer relief and financing programs to assist businesses; however, there are restrictions on stock buybacks during the period in which an issuer obtains a loan or guarantee and for the 12 months after the loan or guarantee is no longer outstanding. A restriction would not be applicable if an issuer already had a contractual obligation to repurchase its shares prior to the enactment of the CARES Act.

Checklist of Key Questions

- ✓ Did the issuer take the recommended steps in connection with establishing its stock repurchase program including obtaining the approval of the board of directors?
- ✓ Did the issuer consider the structure of the proposed repurchase program? Will the issuer seek authority for repurchases up to a specified dollar amount in an identified period or for repurchases of a specified number of shares? Or some combination?
- ✓ Has the issuer consulted with its auditors and tax advisers?
- ✓ Does the issuer intend to rely on the Rule 10b-18 safe harbor? Or will the issuer undertake an ASR? Will either be paired with a Rule 10b5-1 plan?
- ✓ Has the issuer and its board established appropriate controls relating to repurchases and communications with the appointed broker?
- ✓ Does the issuer have a process in place to address suspensions of repurchases if it were to undertake a securities offering?
- ✓ Has the issuer considered how to address any questions that may arise following the announcement of a repurchase program?
- ✓ Has the issuer ensured that there is a process in place to report regularly any repurchases?

Here's the Deal:

- A Rule 10b5-1 plan is a written securities trading plan that is designed to comply with Rule 10b5-1(c) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").
- Any person or entity executing pre-planned transactions pursuant to a Rule 10b5-1 plan that was established in good faith at a time when that person or entity was unaware of material non-public information ("MNPI") has an affirmative defense against accusations of insider trading, even if actual trades made pursuant to the plan are executed at a time when the person or entity may be or is aware of MNPI.
- Rule 10b5-1 plans are especially useful for those presumed to have inside information, such as officers, directors and other affiliates.

What's the Deal?

Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prohibit, among other things, the sale of a security on the basis of MNPI. Rule 10b5-1 specifies that a sale constitutes trading on the basis of MNPI when the person making the sale was aware of MNPI at the time the sale was made. Rule 10b5-1, adopted in August 2000 and amended in December 2022, codifies the position of the Securities and Exchange Commission (SEC) that awareness, not use, of MNPI is sufficient to establish liability in insider trading cases. Importantly, the rule creates a mechanism whereby any person or entity can enter into a trading plan (a "Rule 10b5-1 plan") that will provide an affirmative defense to a claim that a trade occurred "on the basis of" MNPI. An affirmative defense allows a person to refute allegations of wrongdoing – in this case, trading on the basis of MNPI. Rule 10b5-1 plans benefit both issuers and their insiders by offering greater clarity and certainty on how plan participants can structure securities transactions in order to avoid incurring insider trading liability.

Purpose of a Rule 10b5-1 Plan

A Rule 10b5-1 plan provides the following two affirmative defenses against allegations of insider trading so long as the person trading can demonstrate that the purchase or sale occurred pursuant to the terms of a properly designed and implemented trading plan.

- The first affirmative defense, available to both persons and entities, provides that trades pursuant to such a plan are not made "on the basis of" MNPI.
- The second affirmative defense, available only to entities, provides that an entity will not be liable if it demonstrates that the person making an investment decision on behalf of the entity was not aware of MNPI and that the entity had implemented reasonable policies and procedures to prevent insider trading.

Once violations are alleged, the insider will need to set forth all of the elements of the defense, demonstrate that the Rule 10b5-1 plan was properly designed and implemented and show that the trades at issue complied with the terms of the plan.

Benefits of a Rule 10b5-1 Plan

Rule 10b5-1 plans provide the following benefits:

- An affirmative defense to insider trading allegations as described above;
- Greater certainty to insiders in planning securities transactions;
- More opportunities for insiders to sell their securities, especially if the issuer's trading policy permits trading under such a plan during a blackout period;
- Less negative publicity associated with insider sales; and
- Decreased burden on counsel or trading compliance officers who otherwise would have to make subjective determinations about the availability or possession of MNPI each time an insider seeks to effect a securities transaction.

Establishing a Rule 10b5-1 Plan

Any person, including non-insiders, can establish a Rule 10b5-1 plan to effect securities transactions at a time when the person is not aware of MNPI, so long as the plan is not part of a plan or scheme to evade the insider trading prohibitions of the rule and it complies with the below requirements to establish a plan. For example, an executive who receives a significant portion of his or her compensation in stock options may establish a Rule 10b5-1 plan to diversify his or her holdings, or a director may establish a Rule 10b5-1 plan to purchase issuer securities to satisfy stock ownership guidelines. Either example is acceptable, so long as the person establishing the plan did not have access to MNPI at the time the plan was established.

Elements of a Rule 10b5-1 Plan

A Rule 10b5-1 plan provides an affirmative defense only if the following elements are met:

1. The plan was entered into in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1 and the person who has entered into the plan acts in good faith throughout the duration of the trading arrangement.
   - Good faith with respect to trading under a Rule 10b5-1 plan applies to activities within the insider's control, including the ability to directly or indirectly influence the issuer, disclosures or the market in a manner that affects the insider's trades.
2. The plan was adopted at a time when the person trading was not aware of any MNPI.
   - Rule 10b5-1 makes clear that trades are made "on the basis of" MNPI when the person making the purchase or sale was merely "aware" of MNPI, rather than "using" such information, when the purchase or sale was made.

   - Cancellations or modifications of a Rule 10b5-1 plan may not be conducted in a manner to benefit from MNPI.
3. The officer or director certifies in their trading plan that they are not aware of MNPI and are adopting the plan in good faith and not as part of a scheme to evade the prohibitions of the Exchange Act.
4. Excluding Rule 10b5-1 plans adopted by issuers, the plan complies with the mandatory cooling-off period.
   - Trading under a Rule 10b5-1 plan adopted by a director or officer must not begin until the later of (i) 90 days following plan adoption or modification and (ii) two business days following disclosure of the issuer's financial results for the fiscal quarter in which the plan was adopted or modified (but not to exceed 120 days following plan adoption or modification).
   - Trading under a Rule 10b5-1 plan for persons other than issuers or directors and officers (which includes non-officer employees who enter into Rule 10b5-1 plans) must not begin until 30 days following plan adoption or modification.
5. The terms of the plan specified the amount, price and date of the transaction(s) (or included a written formula, algorithm or computer program for determining the amount, price and date).
   - A simple plan may authorize trades on specified dates or at specified prices. A more complicated plan may utilize targets based on the performance of the stock relative to various market or industry indices or even relative to certain selected competitors.
   - The plan itself must sufficiently identify the calculation of the relevant prices and triggers so there is no discretion on the part of the insider. If desired, the plan should incorporate different trading strategies in order to provide flexibility.
6. The person trading under the plan did not exercise any subsequent influence over how, when or whether to make purchases or sales.
   - Typically, the insider establishing the plan designates an administering broker who executes the trades pursuant to the plan.
   - Once the Rule 10b5-1 plan is adopted, there should be no communications between the insider and the administering broker (other than notices that trades have been executed).
   - Rule 10b5-1 prohibits both the insider or the appointed administering broker from entering into or altering a corresponding or hedging transaction or position with respect to securities subject to the plan.
7. The purchase or sale was made pursuant to the plan.
   - Rule 10b5-1(c)(1)(i)(C) specifies that a purchase or sale is not made pursuant to the plan if, among other things, the insider altered or deviated from the plan to purchase or sell securities (whether by changing the amount, price or timing of the purchase or sale).

Trading Under a Rule 10b5-1 Plan

Securities Covered Under a Rule 10b5-1 Plan: There is no restriction on the amount of securities that may be covered by a Rule 10b5-1 plan. A plan may be designed to cover all or a small portion of a person's holdings. The plan should be carefully constructed to include an amount that is suited to the purposes of the person trading. A plan that covers too few securities may require frequent modifications, and a plan that covers too many securities may make it difficult for the insider to take advantage of legitimate trading opportunities outside of the plan.

Rule 10b5-1(c)(1)(iii)(a) defines "amount" as either a specified number of securities or a specified dollar value of securities. Rule 10b5-1(c)(1)(iii)(b) defines "price" as the market price on a particular date or a limit price or a particular dollar price. A Rule 10b5-1 plan can be set up to execute trades with minimum or maximum prices or with prices that change over time, so long as the price targets or the method for determining the price targets are set forth in the plan. Rule 10b5-1(c)(1)(iii)(c) defines "date" as, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). In the case of a limit order, "date" is defined as a day of the year on which the limit order is in force.

Trade Frequency Under a Rule 10b5-1 Plan: A plan can be tailored to the specific needs of the person who sets it up. For example, the plan can specify that trades will be made on a regular basis or the plan can be designed to initiate transactions upon certain trigger events. The SEC does not require a limit on the term of a Rule 10b5-1 plan. A series of short-term plans may subject the insider to allegations of manipulation. On the other hand, plans covering more than a year may deprive the insider of the ability to control the disposition (or acquisition) of securities or to react to significant changes in the issuer's condition or changes in the insider's financial circumstances.

Trades Deemed Outside a Rule 10b5-1 Plan: Trades may be made outside of the Rule 10b5-1 plan. However, the Rule 10b5-1 affirmative defense will not apply to trades made outside of the plan. Additionally, an insider should not sell securities that have been designated as plan securities because any such sale may be deemed a modification of the plan. Further, if the insider is subject to the Rule 144 volume limitations, the sale of securities outside the plan could effectively reduce the number of shares that could be sold under the plan, which could be deemed an impermissible modification of the plan.

Changes to, or Termination of, Rule 10b5-1 Plans

Modifying a Rule 10b5-1 Plan: While amendments to Rule 10b5-1 plans are permitted as long as the modifier does not possess MNPI at the time of the modification and meets all of the elements required at the plan inception, modifications should be avoided because they may create the perception that the person is manipulating the plan to benefit from MNPI, jeopardizing the good faith element and the availability of the affirmative defense.

Suspending a Rule 10b5-1 Plan: The affirmative defense will be unavailable if it appears that the person trading under the plan is exerting subsequent influence over the plan. In addition, suspension of a Rule 10b5-1 plan can lead to the same issues as modification of a plan: it may appear that the plan is being manipulated, jeopardizing the good faith element and the availability of the affirmative defense. When reinstating the ability to trade under the plan, all of the elements required at the inception of the plan must be met again.

Terminating a Rule 10b5-1 Plan: Termination of a plan, by itself, is not a violation of Rule 10b-5, because the termination does not occur in connection with the sale or purchase of securities. However, termination of a plan may jeopardize the good faith element and the availability of the affirmative defense.

Once a Rule 10b5-1 plan is terminated, the affirmative defense may not apply to any trades that were made pursuant to that plan if such termination calls into question whether the good faith requirement was met or whether the plan was part of a plan or scheme to evade Rule 10b5-1. The problem is increased if the insider terminates and establishes plans serially.

Any modification or change to the amount, price or timing of the purchase or sale of the securities underlying a Rule 10b5-1 plan is treated as a termination of the plan and the adoption of a new plan. To the extent that insiders seek to continue to rely on the affirmative defense, they would be subject to a new cooling-off period.

Additionally, cancellation of one or more trades would constitute a "modification." There is no *de minimis* modification exception. In other words, a modification need not be "material" in order for it to trigger a new cooling-off period. However, modifications that do not change the sales or purchase prices or price ranges, the amount of securities to be sold or purchased or the timing of transactions under a Rule 10b5-1 plan (such as an adjustment for stock splits or a change in account information) will not trigger a new cooling-off period.

Automatic Suspension or Termination of a Rule 10b5-1 Plan: To allow persons to make decisions in connection with major corporate transactions and to avoid potential problems under other provisions of the federal securities laws, Rule 10b5-1 plans often include a provision that automatically terminates or suspends trading under the plan upon, among other occurrences, the issuer's announcement (or notice from an issuer's general counsel or compliance officer) of a merger or acquisition transaction or an underwritten public offering.

Prohibitions on Overlapping Plans

Insiders will not benefit from Rule 10b5-1's affirmative defense if the insider establishes multiple overlapping Rule 10b5-1 plans. However, issuers are not included within this prohibition. There are a few limited exceptions to the multiple overlapping plan prohibition. To address an insider's use of multiple brokers to execute trades pursuant to a single Rule 10b5-1 plan that covers securities held in different accounts, a series of formally distinct contracts with different broker-dealers or other agents are treated as a single "plan," but if taken together, the contracts otherwise satisfy the applicable conditions of Rule 10b5-1.

In addition, a broker-dealer or other agent executing trades on behalf of the insider pursuant to the Rule 10b5-1 plan may be substituted by a different broker-dealer or other agent as long as the purchase or sales instructions applicable to the substituted broker and the substitute are identical. This means an insider will not lose the benefit of the affirmative defense when closing a securities account with a financial institution and transferring the securities to a different financial institution. An insider also may maintain two separate Rule 10b5-1 plans at the same time so long as trading under the later-commencing plan is not authorized to begin until after all trades under the earlier-commencing plan are completed or expire without execution, subject to compliance with applicable cooling-off period requirements.

"Sell-to-cover" transactions in which an insider instructs its agent to sell securities in order to satisfy tax withholding obligations at the time an award vests are also permitted so the insider will not lose the benefit of the affirmative defense with respect to an otherwise eligible Rule 10b5-1 plan if the insider has another plan in place that would qualify for the affirmative defense, so long as the additional plan or plans only authorize qualified sell-to-cover transactions. A plan authorizing sell-to-cover transactions qualifies for the new provision where the plan authorizes an agent to sell only such securities as are necessary to satisfy tax withholding obligations incident to the vesting of a compensatory award, such as restricted stock or stock appreciation rights and the insider does not otherwise exercise control over the timing of such sales.

Transactions with the issuer not executed on the open market, such as employee stock purchase plans (ESPPs) or dividend reinvestment plans (DRIPs), would be excluded from the prohibition of overlapping plans.

Impact on Other Federal Securities Laws

A person trading pursuant to a Rule 10b5-1 plan still must comply with other regulatory reporting requirements. If a person is selling securities without registration under the Securities Act of 1933, the person may need to file a Form 144. On Form 144, the seller should indicate that the sale is being made pursuant to a Rule 10b5-1 plan. In addition, the seller may need to comply with the aggregation and volume restrictions of Rule 144.

For U.S. issuers, the Forms 4 and 5 filing requirements also apply to trades made pursuant to a Rule 10b5-1 plan. Persons reporting transactions on a Form 4 or Form 5 pursuant to Section 16 under the Exchange Act are required to identify whether the reported transaction was executed pursuant to a plan "intended to satisfy the affirmative defense conditions" of Rule 10b5-1 by checking a new checkbox on Form 4 and Form 5.

Relatedly, *bona fide* gifts of securities, whether or not part of a Rule 10b5-1 plan, must be reported on a Form 4 by the end of the second business day following the gift. Previously, these transactions are reportable on a Form 5, which is filed once a year within 45 days after the issuer's fiscal year end. Additionally, trades made pursuant to a Rule 10b5-1 plan must be reported under the applicable requirements of Schedule 13D and/or Schedule 13G.

Officers, directors and 10% shareholders utilizing Rule 10b5-1 plans should be careful about trading in violation of Section 16(b) of the Exchange Act. If such a person conducts a purchase and sale, in any order, within a six-month period and realizes a profit, then the profits must be disgorged to the issuer.

Insider Trading Policies

Trades made pursuant to Rule 10b5-1 plans are subject to issuer-specific trading restrictions and may not be permitted under an issuer's trading policy. Typically, an issuer's insider trading policy indicates whether an employee or director may establish a Rule 10b5-1 plan. Some insider trading policies require that a Rule 10b5-1 plan is approved or, at a minimum, that the plan has been established for its securities. An issuer may also require notice if an employee or director establishes a plan to trade securities of a significant customer or supplier. An employee or director should review the issuer's insider trading policy to determine whether the issuer permits establishment of a plan during a blackout period or permits trades during a blackout period pursuant to a plan.

Reporting Requirements

Item 408 to Regulation S-K imposes issuer reporting requirements. Public companies using domestic reporting forms (*e.g.*, Forms 10-Q and 10-K) are required to provide quarterly disclosure of the adoption or termination of Rule 10b5-1 plans and other trading arrangements for directors and officers. Item 408's disclosure requirements apply only to an issuer's directors' and officers' Rule 10b5-1 plans and not to the issuer's.

Disclosures must include the material terms of the Rule 10b5-1 Plan or other arrangement, such as the name and title of the director or officer, adoption or termination date, the duration of the Rule 10b5-1 plan or arrangement, the aggregate number of securities to be sold or purchased pursuant to the Rule 10b5-1 plan or arrangement and whether the arrangement is intended to satisfy the requirements for use of Rule 10b5-1's affirmative defense. However, the disclosure is not required to include the pricing terms of the trading arrangement.

Best Practices

To avoid the appearance that insiders are engaging in abusive practices, issuers should adopt the following requirements for Rule 10b5-1 plans by their directors, officers and other employees:

- Establishment of a Plan: Require issuer approval of any Rule 10b5-1 plan and permit plans to be established only during an open trading window to avoid the appearance of establishing a plan while in possession of MNPI and to bolster the good faith element.
- Waiting Period: Specify the required waiting period between the establishment of a plan and the date the initial trade is made.
- Term of Plan: Consider minimum and maximum terms for plans, such as a minimum of six or 12 months and a maximum of two years. This will enable users to establish new plans over time while eliminating voluntary modifications, terminations or suspensions.
- Form Plan: Consider adopting a pre-approved form of plan.
- One Broker: Consider requiring all insiders to use a pre-selected broker.
- Trading Parameters: Consider prohibiting large sales at initiation of the plan or plans that give the implementing broker discretion on sales.
- Modifications, Terminations or Suspensions: Disallow any modification, termination or suspension other than during open trading windows. In the event of any modification, termination or suspension, issuers should specify the waiting period before trades can be reinstated under a plan.
- Disclosure: Disclose all events in the lifecycle of a Rule 10b5-1 plan: adoption, modification, termination or suspension, either through a press release or by a Form 8-K.
- Multiple Plans: Prohibit insiders from adopting multiple overlapping Rule 10b5-1 plans.
- Trades Outside of the Plan: Once a plan is established, limit transactions outside of the plan.

In addition, the issuer should develop robust training programs regarding its insider trading and disclosure policies and the use of Rule 10b5-1 plans and should consider periodic reviews of insiders' trading plans to ensure compliance with the securities laws and issuer policies.

Checklist of Key Questions

- ✓ Does the issuer require approval of a Rule 10b5-1 plan?
- ✓ What is the duration of the Rule 10b5-1 plan?
- ✓ Does the issuer require all insiders to use a pre-selected broker?
- ✓ Does the issuer prohibit large sales at initiation of the plan or plans that give the implementing broker discretion on sales?
- ✓ Does the issuer prohibit any modification, termination or suspension other than during open trading windows?
- ✓ If there is a modification, termination or suspension to the plan, has the issuer imposed a waiting period before trades can be reinstated under a plan?
- ✓ Does the issuer publicly disclose the existence of insider Rule 10b5-1 plans?
- ✓ Once a plan is established, does the plan limit transactions outside of the plan?

Here's the Deal:

- Medium-term note (MTN) programs are designed to enable frequent debt issuers to access the market quickly, without the burden of negotiating a suite of takedown documents for each debt issuance.
- MTN programs may be either registered with the Securities and Exchange Commission (SEC) or exempt from registration, such as in Section 3(a)(2) bank note programs, Rule 144A and Regulation S programs.
- MTN program documents typically include a distribution or program agreement (which provides a framework for continuous offerings, as opposed to an underwriting agreement used in individual offerings), a fiscal agency agreement or indenture, and ancillary documents, such as a calculation agency agreement.
- MTN offerings settle and clear in the United States through the issuance of securities in global, book-entry form and are held by direct and indirect participants of The Depository Trust Company (DTC).

What's the Deal?

MTN programs enable companies to offer and sell a wide range of debt securities, which may have similar or different terms, on a periodic and/or continuous basis, by using pre-agreed offering and distribution documents and a simplified clearing process. With an MTN program, the issuer is able to use streamlined documentation for each offering and rely on the master program documentation and disclosure documents.

MTN programs were historically developed by the commercial paper departments of investment banks and often were administered by a bank's specialty group rather than through the typical relationship bankers. Most of these offerings are made on a principal or agency basis through the MTN broker-dealer's trading desk. MTNs having tenors of between two to five years were conceptualized as a means to bridge the gap between short-term commercial paper maturing in nine months or less and long-term debt securities maturing 30 years or more from the issuance date. However, it is not unusual for issuers to issue both short-term and long-term securities under an MTN program.

In light of the convenience offered by shelf registration and MTN programs, issuers use MTN programs (i) to effect small- and medium-sized offerings of debt securities to investors that seek specific terms such as a specified principal amount, with a specified credit rating and a specified maturity (known as reverse inquiry trades); (ii) to effect large syndicated offerings of debt securities that might, in the absence of an MTN program, be offered through a traditional shelf takedown; (iii) to offer structured notes, such as equity-linked, index-linked, currency-linked and commodity-linked securities; and (iv) to operate a retail

MTN program wherein an issuer offers MTNs with small minimum denominations to the retail investor market, while limiting administrative costs to the issuer to acceptable levels. In one type of retail MTN program, an issuer will post rates weekly with retail and/or regional brokers. During the week that these rates are posted, the brokerage firms that market the securities to retail investors will place orders in the applicable minimum denominations. At the end of the week, the retail and regional brokerage firms will contact the issuer and indicate the aggregate amount of orders for notes at each maturity, and the issuer will issue one series of notes for each maturity.

Offered Securities

MTN securities historically were principally fixed-rate, non-redeemable senior debt securities and eventually evolved to include other types of debt securities, including floating rate, zero coupon, non-U.S. dollar denominated, amortizing, multi-currency, subordinated or indexed securities. Common reference rates for floating rate securities issued under MTN programs include the secured overnight financing rate (SOFR), Euribor, the prime rate, the Treasury rate, the federal funds rate and the constant maturity swap (CMS) rate. Most MTN programs are rated investment grade by one or more nationally recognized credit rating agencies.

MTNs are usually sold on a best efforts basis. However, competitive pressures may sometimes lead a dealer to purchase MTNs securities as principal, and large syndicated MTN offerings often are effected on a firm commitment basis. In both cases, the MTN dealer is usually regarded as an "underwriter" for liability purposes under Section 11 of the Securities Act of 1933 (the "Securities Act").

The traditional market for MTNs is investor-driven wherein dealers continuously offer MTNs within a specific maturity range, and an investor can negotiate to have the dealer meet its particular investment needs. In making their investment decisions, MTN investors consider credit ratings, an evaluation of the issuer and its business, and the maturity and yield of the MTNs.

MTN Programs: SEC-Registered and Exempt

MTN programs generally are limited to larger public companies with at least a $75 million public equity float and are usually registered on a shelf registration statement under Rule 415 of the Securities Act, specifically under Rule 415(a)(1)(x) for continuous or delayed offerings of issuers that are eligible to use Form S-3 or Form F-3 on a primary basis or under Rule 415(a)(ix) for continuous offerings of issuers that are not eligible to use Form S-3 or Form F-3 and cannot undertake delayed offerings. MTN programs may also be registered on Form S-1 or Form F-1, but this is rare.

Non-SEC reporting companies can also issue MTNs. MTN programs that are not required to be registered with the SEC include (i) bank note programs exempt from registration under Section 3(a)(2) of the Securities Act; (ii) Rule 144A programs in which the securities are offered exclusively to qualified institutional buyers; (iii) private placements made through continuous Section 4(a)(2) offerings; and (iv) Regulation S programs in which the MTNs are offered outside the United States. The issuer and the selling agents for these offerings may use a variety of term sheets to offer these MTNs, which are not subject to the filing requirements of the Securities Act.

Even though MTN offerings under Section 3(a)(2) are exempt from registration under the Securities Act, they are public securities offerings conducted by banks and must be filed with the FINRA for review under

Rule 5110(a)(2) when there is a FINRA member involved in the distribution, unless the issuer has outstanding investment grade-rated unsecured non-convertible debt with a term of issue of at least four years or the non-convertible debt securities are so rated. Transactions under Section 3(a)(2) and Rule 144A must also be reported through FINRA's Trade Reporting and Compliance Engine, or TRACE, to provide greater transparency for investors.

MTN Program Participants

The working group involved in establishing an MTN program generally includes:

- **Issuer,** which usually will be a large corporate or financial services issuer, which has an ongoing need for capital and that is eligible to file a shelf registration statement for delayed and continuous offerings, as well as government-sponsored entities, such as Fannie Mae and Freddie Mac.
- **Guarantor,** (in some cases), such as the issuer's subsidiary or a special purpose finance subsidiary, which may have a higher credit rating on its indebtedness than the issuer.
- **Arranger,** which is usually an investment bank that (i) serves as principal selling agent for the MTNs; (ii) advises the issuer as to potential financing opportunities in the MTN market; (iii) communicates to the issuer any offers from potential investors to buy MTNs; (iv) advises the issuer as to the form and content of the offering documents, including the types of securities to be included; (v) negotiates the terms of the agreements on its own behalf and on behalf of the other selling agents; (vi) coordinates settlement of the MTNs with the issuer, the trustee and the paying agent; and (vii) makes a market in the issued and outstanding securities under the MTN program.
- **Selling Agents,** other than the arranger, are often added to an MTN program if not at establishment, then, through an accession letter, which is a short form of agreement between the issuer and the new selling agents that makes the new selling agents parties to the existing MTN program agreement. Selling agents may be added for the entirety of the program or as dealers for a day to participate in a specific MTN offering. Having multiple selling agents fosters competition among the selling agents to market the issuer's MTNs and helps to attract more reverse inquiry transactions that may likely bring down the issuer's financing costs.
- **Regional dealers,** (in some cases) may be included by the selling agents and, if so, are paid by selling agents through selling concessions.
- **Law Firms,** acting as counsel to the issuer and to the investment banks and, at program establishment, to the trustee or fiscal and paying agent.
- **Accounting firms,** which audit the issuer's financial statements and is expected to deliver a comfort letter at the establishment of the program and then from time to time as required under the distribution agreement.
- **Rating agencies,** (typically at least two) that will provide credit ratings to the issuer's indebtedness generally or credit ratings that are specific to notes issued pursuant to the MTN program.

- **Trustee or fiscal and paying agent,** which serves a variety of roles, including (i) processing payments of interest, principal and other amounts on the MTNs from the issuer to the investors; (ii) communicating notices from the issuer to the investors; (iii) coordinating settlement of the MTNs with the issuer and the selling agent; (iv) assigning security identification codes to the MTNs (in the case of U.S. programs, the trustee typically obtains a block of CUSIP numbers for the relevant issuer's MTN program and assigns them on an issue-by-issue basis); (v) processing certain tax forms that may be required under the MTN program; and (vi) in the case of a trustee of a series of U.S.-registered MTNs, acting as representative of the investors in the event of any claim for payment if a default occurs.
- **Listing agent,** if the relevant MTNs are to be listed or the program is to be qualified for listing on a securities exchange, usually a European securities exchange.
- **Clearing systems,** such as DTC, Euroclear and Clearstream.
- **Financial printer,** to the extent printing is required.

MTN Program Documentation

The offering documents for a registered MTN program may include a "universal" shelf registration statement for debt and other securities or a shelf registration statement relating only to debt securities. The base prospectus, which is included in the registration statement, will include a general description of the issuer's debt securities that may be issued, as well as the possible benchmark rates that may be referenced, and any other potential terms of the securities that are then known. For an exempt MTN program, the offering document will be an offering circular or offering memorandum, rather than a base prospectus, with a form of pricing supplement or final terms to be used for individual offerings made pursuant to the program. In the structured notes context, there may be a need to file a more detailed prospectus supplement describing the notes to be issued under the MTN program, and free writing prospectuses and/or pricing supplements, each of which will include the specific details of each offering or each type of note that may be issued pursuant to the program.

An issuer and the selling agent may also use several other disclosure documents in the offering process, including preliminary and final term sheets, subject to the filing requirements of Rule 433 and other SEC rules relating to "free writing prospectuses" to negotiate the terms of an offering with potential investors, to market an offering or to set forth the agreed-upon final terms of an offering; free writing prospectuses that may be brochures or other educational materials and websites and other types of documents used to market potential offerings from an MTN program; product supplements for issuers of structured products to describe the detailed terms, risk factors and tax consequences of a particular type of product to potential investors; and press releases, particularly in the context of syndicated offerings.

If not otherwise filed with the registration statement, the issuer must also file:

- The **distribution agreement** entered into with the selling agents, which also may be called a "program agreement" or a "sales agency agreement" designed to provide for multiple offerings during the term of the MTN program and typically includes (i) representations and warranties of the issuer, deemed to be made both at the time of the signing of the agreement and at the time of each takedown, as to the accuracy of the offering documents, the authorization of the

WHAT'S THE DEAL? MEDIUM-TERM NOTE PROGRAMS

applicable issuance documents and the indenture or fiscal and paying agency agreement, (ii) the steps to be followed if the MTN prospectus supplement is amended or the size of the program is increased, (iii) the steps to be followed, and the approvals required, if any free writing prospectuses are to be used, (iv) requirements as to the conditions precedent, documents and deliverables required to establish the MTN program and/or conduct takedowns, which may be reverse inquiry transactions, or agented or syndicated takedowns, (v) requirements as to any subsequent deliverables from the issuer to the selling agents, such as periodic comfort letters, legal opinions and officer's certificates, (vi) provisions allocating program expenses among the issuer and the selling agents, (vii) indemnification of the selling agents for liabilities under the securities laws, (viii) provisions relating to the determination of the selling agents' compensation or a schedule of commissions and (ix) provisions for adding additional selling agents, whether for the duration of the program or for a specific offering. Beginning on January 1, 2019, U.S. global systemically important banks and their subsidiaries began adding stay provisions in their securities contracts, such as the distribution agreement. These arose from the qualified financial contract ("QFC") stay rules requiring "covered entities" to include standardized contractual stay language in their QFCs in order to mitigate the risk of destabilizing closeouts of their QFCs, which could be an impediment to an orderly resolution of such financial institutions if there were a failure of such institutions.;

- The **indenture** duly qualified under the Trust Indenture Act of 1939 (in the case of an SEC-registered program), which is usually open-ended, does not limit the amount of debt securities that can be issued and may have restrictive covenants, affirmative covenants and events of default; or *paying agency agreements* (in the case of an exempt or unregistered program);
- An **administrative procedures memorandum**, which is usually an exhibit to the distribution agreement and describes the exchange of information, settlement procedures and responsibility for preparing documents among the issuer, the selling agents, the trustee or paying agent, and the applicable clearing system in order to offer, issue and close each series of securities under the MTN program;
- A **calculation agency agreement** wherein the calculation agent, oftentimes the trustee or the paying agent, agrees to calculate the rate of interest due on floating rate notes;
- An **exchange rate agency agreement** wherein the exchange rate agent, which may be the trustee or paying agent, will, in the case of notes with payments to be made in a non-U.S. currency, convert the non-U.S. currency into U.S. dollars;
- An **Exhibit 5.1 opinion** about the legality of the notes to be issued under the program;
- In the case of complex securities, an **Exhibit 8.1 opinion** on the disclosure of the U.S. federal income tax consequences of investing in the MTNs; and
- The **form of the master note or certificate representing the MTNs**, which typically is in global form, with a single master certificate representing each series, and for more efficient takedowns, containing detailed provisions that could apply to many different types of notes (fixed and floating; the calculation of different types of base rates) and a short leading page or cover page

for the note that indicates (through check boxes and blank lines) which of those detailed terms are applicable to the specific issuance.

Depending upon the arrangements between the issuer and the selling agents, some or all of the comfort letters, opinions and officer's certificates called for by the distribution agreement will be required to be delivered to the selling agents on a periodic basis as part of the ongoing due diligence process because the selling agents are subject to liability as "underwriters" under Section 11 of the Securities Act as noted above. These "deliverables" will help the underwriters establish a "due diligence" defense against any potential Section 11 claims against them for misstatements or omissions in the offering documents.

An MTN program takedown is intended to be relatively straightforward since the distribution or program agreement and the principal governing documents were negotiated and agreed when the program was established. The issuer and the arranger (and the other selling agents, if applicable) will agree on the terms of the takedown, commonly done orally with written confirmation to follow; and the agents will deliver the base prospectus, MTN prospectus supplement and pricing supplement to investors (which may occur via "access equals delivery" under SEC Rule 172 in the case of a registered program). In the case of a syndicated MTN issuance, an updated comfort letter, legal opinions and one or more officers' certificate are also provided to the selling agents at the closing of the offering. For a registered offering, the issuer will file with the SEC under Rule 424 a pricing supplement containing the title of the securities, issue date, maturity date, interest rate, any redemption dates, the names of the underwriters or selling agents and their compensation for the offering, and the legal opinion language. The issuer will also instruct the trustee or issuing and paying agent to complete the form of the note or certificate representing the MTNs in global or certified form.

Checklist of Key Questions

- ✓ Is the establishment of an MTN program consistent with the issuer's financing needs, taking into consideration the costs and process for periodic deliverables and due diligence?
- ✓ Does the issuer's board of directors and pricing committee understand the MTN program structure?
- ✓ Does the base prospectus or offering circular describe the range of potential benchmark rates that may be used by the issuer? Are there provisions regarding the transition away from IBOR rates?
- ✓ If there is a limit specified in the MTN prospectus supplement, is there a sufficient amount available for issuance taking into consideration both the amounts authorized and issued?
- ✓ Are the selling agents acting on a best efforts or firm commitment basis?
- ✓ Is the selling agent an affiliated broker-dealer of the issuer? If so, are the potential conflicts of interest disclosed in the manner required by FINRA rules?
- ✓ Is the MTN program rated investment grade to exempt the issuer from FINRA's Rule 5110 review?
- ✓ What documents will be required to be delivered on a quarterly (or other periodic) basis by the issuer to the selling agents?
- ✓ What documents are required to be negotiated and entered into in connection with a syndicated offering?
- ✓ If there is no selling agent for a particular issuance, has the issuer made arrangements for DTC settlement through the trustee?

Here's the Deal:

- Section 3(a)(2) bank note programs are medium-term note programs with a "bank" as the issuer
- The issuer must be a "bank," as defined in Section 3(a)(2) of the Securities Act
- Bank note programs allow the issuer to access the market quickly without the delay associated with SEC review and to do so on a regular or continuous basis
- Securities issued pursuant to a Section 3(a)(2) bank note program are exempt from SEC registration

What's the Deal?

Section 3(a)(2) of the Securities Act of 1933 (the "Securities Act") exempts from registration under Section 5 of the Securities Act any security issued or guaranteed by a "bank." The policy underlying this exemption from the registration requirements of Section 5 of the Securities Act is that banks are highly regulated and provide adequate disclosure to investors about their businesses and operations in the absence of federal securities registration requirements. Banks are also subject to various regulatory capital requirements that may serve to increase the likelihood that holders of their debt securities will receive timely payments of principal and interest.

What is a "Bank?"

Under Section 3(a)(2), an institution must meet both of the following requirements: (1) it must be a national bank or an institution supervised by a state banking commission or similar authority and (2) its business must be substantially confined to banking. Entities that sound like banks but do not qualify include, bank holding companies, finance companies, investment banks and foreign banks. As discussed below, regulated U.S. branches and agencies of foreign banks may qualify as a "bank."

What Types of Securities are Generally Issued Pursuant to Bank Note Programs?

Common types of issuances include senior or subordinated debt securities, such as fixed or floating rate, zero-coupon, non-U.S. dollar denominated, amortizing, multicurrency or indexed ("structured" or "market-linked") debt securities. Most bank note programs are rated "investment grade" by one or more nationally recognized credit rating agencies, as further discussed below. Bank issuers often use bank note programs to issue Section 3(a)(2) structured notes, the payments on which are linked to the performance of specified reference assets not always seen in registered programs, such as complex underlying assets, credit-linked notes, small-cap stocks and non-U.S. stocks, that do not trade on U.S. securities exchanges.

Is a Non-U.S. Bank an Eligible Issuer for a Section 3(a)(2) Bank Note Program?

Generally, no. However, U.S. branches or agencies of foreign banks are conditionally entitled to rely on the Section 3(a)(2) exemption. In 1986, the U.S. Securities and Exchange Commission (SEC) took the position that a foreign branch or agency would be deemed a "national bank" or a "banking institution organized under the laws of any State, Territory, or the District of Columbia," if "the nature and extent of federal and/or state regulation and supervision of that particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction."[2] It is the responsibility of the issuer and its counsel to make the determination with respect to the requirement of "substantially equivalent regulation," as well as the determination as to whether the business of the branch or agency in question "is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." As a result, U.S. branches or agencies of foreign banks are frequent issuers or guarantors of debt securities in the United States. Most U.S. branches have elected the N.Y. State Department of Financial Services (NYDFS) as their primary regulator with their secondary regulator being the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Some U.S. branches have opted for the Office of the Comptroller of the Currency (OCC) as their primary regulator.

How Does a Guarantee Allow a Non-Bank Issuer to Issue Under Section 3(a)(2)?

Section 3(a)(2) also exempts from registration under Section 5 of the Securities Act securities guaranteed by a bank. This guarantee is not limited to a guarantee in a legal sense, but also includes arrangements in which the bank agrees to ensure the payment of a security. The guarantee or assurance of payment, however, has to cover the entire obligation; it cannot be a partial guarantee or promise of payment, and it must be unconditional. Guarantees by foreign banks (other than those of an eligible U.S. branch or agency) would not qualify for this exception. The guarantee is a legal requirement to qualify for the exemption; investors will not look to the U.S. branch for payment/credit. Investors will look to the home office. Foreign banks and finance companies, for example, can rely on the Section 3(a)(2) exemption if the securities they issue are guaranteed by a bank.

Do State or Federal Banking Regulators Impose Any Conditions on Bank Note Programs?

National banks or federally licensed U.S. branches or agencies of foreign banks regulated by the OCC are subject to the OCC's securities offering disclosure rules (12 C.F.R. Part 16). The securities offering disclosure rules provide that national banks may not offer and sell their securities until a registration statement has been filed and declared effective with the OCC, unless an exemption applies.

An OCC registration statement is generally comparable in scope and detail to an SEC registration statement; as a result, most bank issuers prefer to rely upon an exemption from the OCC's registration requirements. Section 16.5 of the securities offering disclosure rules provides a list of exemptions, which includes Regulation D offerings, Rule 144A offerings to qualified institutional buyers and Regulation S offerings made outside of the United States. General solicitation would be allowed for Regulation D offerings and Rule 144A offerings; the Rule 506 "bad actor" disqualification provisions would also apply.

[2] Securities Issued or Guaranteed by United States Branches or Agencies of Foreign Banks, SEC Release No. 33-6661 SEC Docket (1973-2004), 36 SEC-DOCKET 746-1 (September 23, 1986).

Part 16.6 of the securities offering disclosure rules provides a separate partial exemption for offerings of "non-convertible debt" made to accredited investors in denominations of $250,000 or more. Federal branches or agencies of foreign banks, as issuers, may rely on this exemption by furnishing to the OCC parent bank information that is required under Securities Exchange Act of 1934 ("Exchange Act") Rule 12g3-2(b) and to purchasers the information required under Securities Act Rule 144A(d)(4)(i). The securities must be "investment grade" — the definition focuses on the probability of repayment rather than on an external investment grade rating (a Dodd-Frank Act requirement). Prior to, or simultaneously with, the sale of the securities, the purchaser must receive an offering document that contains a description of the terms of the securities, the use of proceeds and the method of distribution and incorporates certain financial reports or reports filed under the Exchange Act. The offering document and any amendments must be filed with the OCC no later than the fifth business day after they are first used.

Are There Any Relevant Regulations Affecting Securities Offerings by State-Regulated Banks?

Currently, offerings of securities made by state non-member banks are subject to the Statement of Policy Regarding the Use of Offering Circulars in Connection with Public Distribution of Bank Securities (the "1996 FDIC Policy"). The 1996 FDIC Policy affects state nonmember banks (banks that are supervised by the FDIC rather than the Federal Reserve) and state-licensed branches of foreign banks with insured deposits. The 1996 FDIC Policy requires that an offering circular include prominent statements that the securities are not deposits, are not insured by the FDIC or any other agency, and are subject to investment risk. The 1996 FDIC Policy also states that the offering circular should include detailed prospectus-like disclosure, similar to the type contemplated by Regulation A or the offering circular requirements of the former Office of the Thrift Supervision (OTS). The 1996 FDIC Policy has not been updated to reflect the elimination of the OTS. In practice, bank issuers include offering circular disclosure that is more detailed than that required by the 1996 FDIC Policy due to liability concerns.

On January 19, 2021, the FDIC proposed rescinding the 1996 FDIC Policy and replacing it with a new regulation to be codified in Subpart A of 12 C.F.R. Part 335, as "Securities of State Nonmember Banks and State Savings Associations" (the "Proposed Rule").[3] The Proposed Rule is limited in its scope as opposed to the 1996 FDIC Policy, which applies to all state nonmember banks. The Proposed Rule applies to offerings of bank securities in the following circumstances: (1) FDIC-supervised institutions (*i.e.,* state nonmember banks and state savings associations) in organizations; (2) FDIC-supervised institutions subject to an enforcement order or capital restoration plan that intend to issue securities; (3) FDIC-supervised institutions converting from a mutual to stock form of ownership; and (4) subsidiaries of state savings associations in any of (1)-(3).

Unlike under the 1996 FDIC Policy, an insured state nonmember bank issuing debt securities outside of (1)-(3) above would not be subject to the Proposed Rule. However, the Proposed Rule is instructive as to the type of disclosure to include in an offering circular for an offering of bank securities by a state nonmember bank and the FDIC indicates that, in its experience, many state nonmember banks comply with federal securities offering rules even if they are not legally required to do so.

[3] The Proposed Rule is available at: https://bit.ly/3sz7wUt.

State nonmember banks and state savings associations subject to the Proposed Rule would be required to file a registration statement, including a prospectus, with the appropriate regional FDIC office, notwithstanding the availability of the Section 3(a)(2) exemption. The registration statement and prospectus would need to conform to Regulation C under the Securities Act unless provided otherwise in the Proposed Rule. With respect to disclosure, the documents would need to conform to the requirements of Regulations S-K and S-X under the Securities Act. As in the 1996 FDIC Policy, the standard legends (*i.e.,* the securities are not deposits, not FDIC-insured, no approval by the FDIC is implied and debt securities are subordinated to deposits) would need to be included in the offering circular in bold capital letters.

New York branches or agencies of foreign banks should contact the NYDFS prior to issuing bank notes. An agency of a foreign bank subject to New York banking regulations should obtain a pre-offer no-objection letter from the Superintendent of the NYDFS and would be able to sell only to certain authorized institutional purchasers in minimum denominations of $100,000. New York branches of foreign banks typically issue bank notes in high minimum denominations in order to avoid the notes being viewed by a regulator as an impermissible retail deposit. This limitation does not apply when the New York branch is a guarantor and the issuing entity is the foreign bank.

Are There any FINRA Filing Requirements?

Even though securities offerings under Section 3(a)(2) are exempt from registration under the Securities Act, public securities offerings conducted by banks must be filed with the FINRA for review under Rule 5110(b)(9), unless an exemption is available. The exemption most used for bank note programs is that the issuer has outstanding investment grade rated unsecured non-convertible debt with a term of issue of at least four years or the non-convertible debt securities to be issued under the bank note program are so rated.

If an affiliated dealer is an agent for the offering, there is "prominent disclosure" in the offering document with respect to the conflict of interest caused by that affiliation and the bank notes are rated investment grade or in the same series that have equal rights and obligations as investment grade rated securities, then no qualified independent underwriter will be required.

Is there a minimum denomination requirement?

The Section 3(a)(2) exemption is not conditioned on a specific minimum denomination. However, for a variety of reasons, denominations may at times be significantly higher than those for retail transactions:

- Offerings targeted to institutional investors;
- Complex securities; and
- The relationship to Part 16.6's requirement of $250,000 minimum denominations.

Is any Action Required Under the State Securities, or Blue Sky, Laws?

Securities issued under Section 3(a)(2) are considered "covered securities" under Section 18 of the Securities Act. However, because bank notes are not listed on a national securities exchange, states may require a notice filing and a fee in connection with an offering of bank securities. Generally, blue sky filings are not needed in any state in which the securities are offered. State blue sky laws should be

examined to ensure that either no notice filing or fee is required or if the state's existing exemption for securities issued by banks does not require a filing. A state may not view an agency of a foreign bank, the securities of which are eligible for the Section 3(a)(2) exemption, as within the state's exemption for securities issued by banks.

What Kind of Offering Documentation is Used in Bank Note Programs?

The offering documentation for bank notes is similar to that of a registered debt offering. Issuers use a base offering document, which may be an "offering memorandum" or an "offering circular" (instead of a "prospectus"). For foreign issuers, International Financial Reporting Standards (IFRS) financials or "home country" generally accepted accounting principles (GAAP) financials are acceptable. However, offering documents of foreign issuers will need a reconciliation footnote or explanation if non-U.S. GAAP or non-IFRS is used. U.S. GAAP financials are preferable. The market demands annual audited and at least semiannual unaudited financial statements. Typically, the equivalent of Industry Guide 3 statistical disclosures (now, Regulation S-K subpart 1400) or something similar are included.

The base document is supplemented for a particular offering by one or more "pricing supplements" and/or, in the case of structured notes, "product supplements." These offering documents may be supplemented by additional offering materials, including term sheets and, for structured products, brochures.

How Does a Bank Initiate a Bank Note Program?

One threshold question is whether the bank has an affiliated dealer that may be the lead dealer for the program. If the affiliated dealer does not have expertise in the particular market (*e.g.,* structured products), an unaffiliated dealer with expertise should be brought in. If the bank plans to issue structured products, it should engage a dealer that is familiar with FINRA's suitability rules and Regulation Best Interest under the Exchange Act and has internal compliance procedures in place for sales of structured products.

If a foreign bank is the issuer, the dealer may have particular views as to acceptable financial statements. If the dealer plans on distributing through third-party dealers, the issuer should inquire about the dealer's "know your distributor" policies. If the issuer uses an affiliated dealer, the appropriate FINRA filing exemption must be used. Dealer's counsel will want to start its diligence early in the process in order to identify any potential issues.

The offering circular tends to have information similar to that in a registered offering due to liability concerns. As a guide, one could look to the content requirements in Part 16.6 of the securities offering disclosure rules:

- Description of the business of the issuer similar to that included in a Form 10-K;
- Description of the terms of the notes;
- Use of proceeds; and
- Method of distribution.

A U.S. bank will incorporate by reference into the offering circular the Exchange Act reports filed by its parent bank holding company, together with the bank's Call Reports.

Branches or agencies of foreign banks' disclosure is very limited – usually the address, primary business lines and the date of establishment. Disclosure about the parent or headquarters is usually sufficient. If a guarantee structure is used, a description of the guarantee will be included. Bank note programs for structured products will have product and pricing supplements for particular structures.

The distribution agreement is very similar to a distribution agreement for a registered medium-term note program. In negotiating the distribution agreement, attention should be paid to the required deliverables (comfort letters, officers' certificates and opinions) and when they will be delivered. Generally, these deliverables are delivered at the program launch and may also be delivered on a quarterly basis for active bank note programs. If there is a large, benchmark-size takedown from the bank note program, the agents on the program will require a full set of deliverables for that takedown.

The scope of the opinions should be negotiated early in the process. Consider whether there will be multiple counsel delivering legal opinions (U.S., non-U.S., internal, dealers' counsel). Issuers should plan for future, regular diligence sessions with the agents. If the issuer has designated dealers' counsel, they will have a preference as to the form of the distribution agreement.

Unlike registered medium-term note programs, bank note programs generally do not use an indenture. Qualification of an indenture under the Trust Indenture Act of 1939 is not required for an exempt offering. Instead, a fiscal and paying agency agreement is generally used. Disclosure in the description of the notes should clearly point out the differences between an indenture and a fiscal and paying agency agreement (*i.e.,* there is no trustee in a fiduciary relationship with the note holders and note holders have to accelerate their own note if there is an event of default).

What Liabilities Flow to the Issuer from Offerings Under a Bank Note Program?

Securities offerings of, or guaranteed by, a bank under Section 3(a)(2) are not subject to the civil liability provisions under Section 11 and Section 12(a)(2) of the Securities Act. These offerings are subject to Section 10(b) of the Exchange Act and the antifraud provisions of Rule 10b-5 of the Exchange Act. This has an impact on the content of offering documents and the use of offering circulars to convey material information and risk factors.

Rule 10b-5 applies to registered and exempt offerings. Rule 10b-5 of the Exchange Act prohibits:

- The use of any device, scheme or artifice to defraud;
- The making of any untrue statement of a material fact or the omission of a material fact necessary to make the statements made not misleading; or
- Engaging in any act, practice or course of business that would operate to deceive any person in connection with the purchase or sale of any securities.

To bring a successful cause of action under Rule 10b-5, plaintiffs must prove that:

- There was a misrepresentation or failure to disclose a material fact;
- The misrepresentation was made in connection with plaintiffs' purchase or sale of a security;

- Defendants acted with "scienter," or the intent or knowledge of the violation;
- Plaintiffs "relied" on defendants' misrepresentation or omission; and
- Such misrepresentation or omission caused plaintiffs' damages.

Checklist of Key Questions

- ✓ Is the issuer or the guarantor a bank?
- ✓ Does the issuer have an affiliated broker-dealer that will be involved in the bank note program?
- ✓ If the issuer is a foreign bank is there a guarantee by a U.S. branch or agency?
- ✓ Will the issuer's financial statements be prepared in compliance with IFRS or U.S. GAAP?
- ✓ If the bank note program is intended to be used to offer and sell structured products, does the lead dealer have experience in this area?
- ✓ Will the bank note program be rated investment grade or be *pari passu* with securities of the same issuer that are so rated?

Here's the Deal:

- Structured certificates of deposit are financial instruments representing a deposit of a specified amount of money for a fixed period of time.
- Unlike traditional certificates of deposit, structured certificates of deposit may pay an additional (or "supplemental") payment, either at maturity or through periodic interest payments, based on the performance of a reference asset.
- A portion of the payments under a structured certificates of deposit are covered by FDIC insurance, as discussed below.
- Generally, structured certificates of deposit are not subject to the registration requirements of the federal securities laws since FDIC-insured certificates of deposit are bank deposits, generally exempt from the definition of "security."

What's the Deal?

Structured certificates of deposit (SCDs) are financial instruments representing a deposit of a specified amount of money for a fixed period of time. As with traditional certificates of deposit (CDs), SCD holders are entitled to their principal, plus possible additional payments. However, unlike traditional CDs, which usually pay interest periodically based on a fixed or floating rate, SCDs may pay an additional payment at maturity or periodic interest payments based on the performance of a reference asset, such as one or more equity securities, an index, or one or more currency exchange rates. SCDs are customizable and can be tailored to fulfill specific investment objectives.

Sample Terms of Structured Certificates of Deposit

Bank A issues a certificate of deposit with a three-year term, a 100% participation rate and a minimum investment of $1,000. In lieu of a fixed interest rate, Bank A has offered to pay an amount equal to the appreciation of the S&P 500® (the "SPX") over that three-year term. If the SPX increases by 20% in the three-year time period, Bank A will pay $200 for each $1,000 invested plus the $1,000 in principal, or $1,200 in total. However, if the SPX declines, Bank A will only pay the holder the principal amount at maturity.

Reference Assets that May Be Linked to Structured Certificates of Deposit

SCD investors are entitled to the principal amount invested plus a return based on the performance of a reference asset. Examples of reference assets include single stocks, ETFs, equity indices (*e.g.*, the Dow Jones Industrial Average and SPX), interest rates, foreign currency exchange rates, commodities (*e.g.*, futures contracts on oil and gas or gold prices) or some combination of any of these. With SCDs, it is possible to reference the performance of a broader range of reference assets compared to registered structured notes.

Characteristics of Structured Certificates of Deposit

STRUCTURED CERTIFICATES OF DEPOSIT VS. TRADITIONAL CDs

SCDs possess a number of characteristics that are distinct from traditional CDs.

First, unlike traditional CDs, SCDs do not generally pay a fixed or floating interest rate; instead, they generally pay an additional payment at maturity or periodic interest payments based on the performance of a reference asset.

Second, SCDs are customized instruments, which provide investors access to numerous investment strategies, as well as opportunities to gain upside exposure to a variety of markets and reference assets.

Third, SCDs may or may not bear interest and may offer a comprehensive selection of payment calculations. For example, payments may be calculated using the percentage increase of the reference asset based on the starting level (determined on the pricing date) and the ending level (determined shortly before the maturity date) or may be calculated using the average of the levels of the reference asset, based on a series of observation dates throughout the term of the SCDs. In the alternative, the payments may be subject to a cap, or ceiling, representing a maximum appreciation in the level of the reference asset.

STRUCTURED CERTIFICATES OF DEPOSIT AND WITHDRAWAL PRIOR TO MATURITY

SCDs usually may not be withdrawn prior to maturity. However, depending on the terms of the particular SCD, an issuing bank may offer an "estate feature" (otherwise commonly known as a "death put" or a "survivor's option"). If the depositor of an SCD passes away (or, in some cases, becomes legally incapacitated), the estate or legal representative has the right, but not the obligation, to redeem the SCD for the full deposit amount before the maturity date, without being subject to any penalty provisions. The estate or representative may choose not to exercise the estate feature and instead hold the SCD to maturity. This term is often offered by an issuing bank as an extra purchase incentive; an investor need not worry that his or her descendants will end up holding a long-term instrument that they don't wish to sell at a discount to face value.

PERFORMANCE OF A SCD COMPARED TO THAT OF A TRADITIONAL CERTIFICATE OF DEPOSIT

SCDs may underperform traditional certificates of deposit. Unlike traditional CDs, which provide for a fixed rate of return, the rate of return for an SCD is contingent on the performance of the reference asset. There may be no assurance of any return, or payment, above the deposit amount. While an investor is guaranteed his or her principal amount, in the end, if the reference asset fails to perform well, the investor will still experience an "opportunity cost," compared to having invested in a traditional, interest-paying CD.

PARTICIPATION RATE AND SCDs

The "participation rate" is the exposure of a product to movements in the price or level of the reference asset. A participation rate of 100% would generate a return equal to any increase in the value of the reference asset. Conversely, if the participation rate is 80%, an investor will receive 80% of the increase in

the value of the reference asset. In such a case, the SCD will underperform the reference asset if the value of the reference asset increases.

OTHER FEATURES THAT COULD LIMIT AN INVESTOR'S RETURN AT MATURITY

Even if the reference asset performs well, depending on the terms of a SCD, the return on the investment may be limited by a predetermined return (a "cap") or some other term specific to a particular SCD. These types of features could cause the SCD to perform less well than the relevant reference asset. Further, because SCDs are insured by the Federal Deposit Insurance Corporation (FDIC), the premiums and assessments paid by the bank issuer to the FDIC are usually passed on to the investor in the form of a lower participation rate or a lower maximum payment, as compared to non-FDIC-insured investments.

CALL FEATURES AND STRUCTURED CERTIFICATES OF DEPOSIT

A "call feature" allows an issuing bank, at its discretion, to redeem a SCD at a call price on a specified call date or dates, prior to maturity. By agreeing to a specified call price, the investor effectively forgoes any possible returns that could be realized had the SCD not been called or had the SCD been called on a later date. In addition, if a SCD is called, the investor may not be able to reinvest the proceeds in a similar instrument, since interest rates and the level of the reference asset may have changed since the SCD was initially purchased.

Benefits Associated with Structured Certificates of Deposit

SCDs can be a relatively low-risk alternative to other investment vehicles because they guarantee payment of the deposit amount at maturity. Regardless of the performance of the reference asset, at maturity, a holder of FDIC-insured SCDs will still receive the original investment amount (even if the issuing bank is no longer solvent).

However, it is important to note that SCDs only benefit from principal protection if the investment is held to maturity.

FDIC Insurance and Structured Certificates of Deposit

AMOUNT OF INVESTOR'S DEPOSIT INSURED BY THE FDIC

FDIC insurance coverage applies to bank products that are classified as "deposits." Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the FDIC now covers up to $250,000 of an investor's deposits with the relevant bank. However, the determination of how the $250,000 limit applies to different types of accounts can be complex.[4]

LIMITATIONS TO THE FDIC COVERAGE

The guarantee by the FDIC is limited to the principal invested and any guaranteed interest rate, but does not extend to the amount of any "contingent" interest. For example, in the hypothetical scenario outlined above, if the issuing bank were to fail prior to maturity of the SCD, the FDIC insurance would only cover the $1,000 investment, but not the $200 of earnings based on the performance of the SPX. In addition, if an investor pays a purchase price for the SCDs that exceeds the par amount of the deposit, for example,

[4] *See* the FDIC's website for examples: http://www.fdic.gov/deposit/deposits/.

paying $1,005 for a $1,000 SCD in the secondary market, the premium paid by the investor would not be covered by FDIC insurance.

Further, investors are still subject to the direct credit risk of the issuing bank for any dollar amount over the maximum applicable deposit insurance coverage. This would occur, for example, if the investor holds other deposits with the applicable bank that together exceed $250,000.

Other Banking Laws and Structured Certificates of Deposit

STRUCTURED CERTIFICATES OF DEPOSIT AND PRINCIPAL PROTECTION

If a SCD is intended to be covered by FDIC insurance then it must be principal protected. FDIC insurance extends only to those bank products that are regarded as deposits. The FDIC has taken the position that an instrument must guarantee the repayment of principal in order to be treated as a deposit.

THE APPLICABILITY OF THE TRUTH-IN-SAVINGS ACT TO STRUCTURED CERTIFICATES OF DEPOSIT

Federal Reserve Regulation DD (which implements the Truth-in-Savings Act) requires issuing banks to make certain disclosures with regard to deposit accounts "held by or offered to" consumers in order to enable consumers to make informed decisions about accounts such as SCDs. Section 1030.8 of Regulation DD ("Section 1030.8") prohibits an issuing bank from advertising its deposit accounts in any way that is inaccurate or misleading. The regulation contains a variety of specific disclosure rules with which issuers of CDs must comply. For instance, banks are prohibited from using the word "profit" in referring to interest payments or using the words "free" or "no cost" if a maintenance or activity fee is imposed on the account. Banks are also obligated to comply with Section 1030.8's advertising rules regarding rates of return. For example, an issuing bank must state certain types of interest payments as an "annual percentage yield," and disclose any and all fees associated with the deposit, such as ladder rates on various CDs, as well as any penalty fees that may be imposed for early withdrawal.

Additionally, the Federal Trade Commission Act prohibits unfair or deceptive acts or practices, which applies to all aspects of a depositary institution's consumer products and services, including advertisements.

Securities Law Considerations for Structured Certificates of Deposit

STRUCTURED CERTIFICATES OF DEPOSIT AND THE REGISTRATION REQUIREMENTS OF THE FEDERAL SECURITIES LAWS

SCDs are generally not subject to the registration requirements of the federal securities laws. Section 2(a)(1) of the Securities Act of 1933 (the "1933 Act") includes "certificates of deposit" in the definition of the term "security." However, under relevant federal judicial and regulatory proceedings, FDIC-insured certificates of deposit are generally exempt from the definition of "security" under the federal securities laws. The Supreme Court, in its analysis of CDs, found that since holders of CDs are guaranteed payment of principal by the FDIC, and a variety of other protections are provided to depositors under applicable banking laws, it was not necessary to provide to CD holders the added protections afforded under the federal securities laws.

CIRCUMSTANCES IN WHICH A SCD MAY BE DEEMED TO BE A SECURITY UNDER THE FEDERAL SECURITIES LAWS

Typically, CDs, including SCDs, are not considered securities under the 1933 Act. However, there are limited instances where courts have been willing to characterize CDs as securities.

In *Gary Plastics Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, 756 F.2d 230 (2d Cir. 1985), Merrill Lynch marketed insured certificates of deposit that it obtained from various banks. Merrill Lynch purportedly promised to maintain a secondary market to guarantee purchasers liquidity for their deposits and represented to purchasers that it had reviewed the financial soundness of the issuing banks. Due to the fact that the broker's creation and maintenance of a secondary market was a critical part of its marketing efforts and permitted investors to make a profit from these investments, the additional protection of the 1933 Act was deemed appropriate. In its analysis, the Second Circuit Court of Appeals analogized CDs to "investment contracts." An instrument is an "investment contract" if it evidences: (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) to be derived from the entrepreneurial or managerial efforts of others. Due to the fact that the broker's creation and maintenance of a secondary market was a critical part of its marketing efforts and permitted investors to profit from these investments, the additional protection of the 1933 Act was deemed appropriate.

As a result of this case, brokers who offer these products indicate that they may make a secondary market in them (and in fact many do), however, these issuances do not involve a commitment or an agreement on the part of any broker to do so.

FINRA RULES AND STRUCTURED CERTIFICATES OF DEPOSIT

Since SCDs are generally not "securities", many Financial Industry Regulatory Authority, Inc. ("FINRA") rules not technically apply to sales of SCDs. Nevertheless, most broker-dealers apply a comparable degree of compliance procedures to SCDs as they do in the case of securities. Additionally, broker-dealers may still need to consider FINRA's requirements regarding investor suitability and retail communications in connection with SCDs.

STRUCTURED CERTIFICATES OF DEPOSIT AND OTHER REGISTRATION REQUIREMENTS

Issuing banks that are engaged in the offer and sale of securities may still need to comply with the registration requirements of the Office of the Comptroller of the Currency (OCC). The OCC's securities offering rules apply to U.S. national banks and federal branches and agencies of non-U.S. banks. The OCC's securities offering disclosure regulations provide that, absent an available exemption, no bank may offer or sell securities without meeting the registration requirements of 12 C.F.R. 16 ("Part 16"). Like the registration requirements under the Securities Act, Part 16 aims to provide the investing public with full disclosure of the material facts and circumstances regarding the offer and sale of securities by national banks. In fact, Part 16 incorporates by reference a variety of the definitions, registration and prospectus delivery requirements of the 1933 Act, as well as the implementing rules of the Securities and Exchange Commission (SEC), including the definition of "security." As a result, most FDIC-insured SCDs are exempt from registration under the OCC's rules, for the same reasons that result in their exemption from registration under the 1933 Act.

APPLICABILITY OF "BLUE SKY LAWS" TO STRUCTURED CERTIFICATES OF DEPOSIT

The registration requirements imposed by each state's Blue Sky laws do not apply to SCDs since they are usually not considered securities under federal securities laws. Further, under the National Securities Markets Improvement Act of 1996, federal law preempts the application of Blue Sky laws for certain categories of securities, known as "covered securities." Included in the definition of "covered securities" are certain securities exempt under Section 3(a) of the 1933 Act. These include any security issued or guaranteed by any bank. Because SCDs are issued by banks, even if they were securities, they would be "covered securities" and out of scope of the Blue Sky laws.

Documentation for Structured Certificates of Deposit

DISCLOSURE REQUIREMENTS FOR ISSUING BANKS

While SCDs are generally excluded from the registration requirements under the 1933 Act, they may not be excluded from certain disclosure requirements by self-regulatory organizations. For instance, in 2006, the New York Stock Exchange (NYSE), published Information Memo 06-12 addressing the disclosure and sale practices concerning SCDs. A key concern of the NYSE was the adequacy of the disclosure materials used in connection with the sale of SCDs and whether an investor would fully understand how these differ from conventional CDs. The NYSE required that its member organizations be able to identify the customer criteria that define the appropriate market for a particular SCD and provide training to their registered representatives to assure that they can identify investors for whom the SCD may be suitable. From a disclosure standpoint, the NYSE required its member organizations to make appropriate disclosures to investors prior to, or at the time of, the sale. In addition, member organizations must clearly explain the risks associated with SCDs. Such risks include, but are not limited to, market risks, liquidity risks, tax implications and any potential call features (if applicable).

The SEC has also indicated some of the concerns that it has had as to the disclosures made in connection with sales of SCDs. For example, the SEC added a page to its website, "Equity Linked CDs" (http://www.sec.gov/answers/equitylinkedcds.htm), which serves as a reminder to issuers and brokers of SCDs of certain key disclosure issues.

In addition, Federal Reserve Regulation DD (which implements the Truth in Savings Act) sets forth additional disclosure requirements.

STRUCTURED CERTIFICATES OF DEPOSIT DISCLOSURES AND DISCLOSURES USED IN MEDIUM-TERM NOTE PROGRAMS

Mirroring the types of disclosures traditionally found in medium-term note programs offers issuing banks some advantages and allows them to accomplish a number of objectives. First, following the disclosures in medium-term note programs address potential concerns raised by the NYSE, FINRA and Regulation DD. Second, the disclosures provide investors with the level and quality of information that regulators have traditionally deemed adequate for investors to make an investment decision. Last, since many issuing banks that offer SCDs also offer structured securities programs, providing similar types of documentation for SCDs offers investors familiar disclosures.

OTHER OFFERING DOCUMENTATION USED IN A STRUCTURED CERTIFICATE OF DEPOSIT PROGRAM

Many issuing banks market SCDs in a manner that is similar to the manner in which they market notes offered pursuant to their medium-term note programs. For the SCDs that are marketed by larger, more frequent issuers, the related documents that are prepared and distributed to investors are similar to those used in structured note offerings. For example, an issuer may provide SCD investors with a "pricing supplement," which sets forth the specific terms of a particular SCD (including the terms of the SCD, a comprehensive discussion of the economic terms of the offering, and a discussion of the underlying asset, specific risk factors, fees and expenses), a "product supplement" and a base disclosure statement.

TYPES OF DOCUMENTS AND AGREEMENTS USED TO ESTABLISH A STRUCTURED CERTIFICATE OF DEPOSIT PROGRAM

Establishing a SCD program typically requires a variety of additional agreements and documents, including:

- A brokerage or purchase agreement between the issuing bank and the brokers that will market the SCDs.
- A paying agency agreement with a paying agent (if necessary).
- Forms of master certificates that represent the SCDs.
- Documentation providing for the clearance of the SCDs through the facilities of The Depository Trust Company.
- Agreements with hedging counterparties, in the event the issuing bank is engaged in hedging activities.

Many brokers will often on-sell SCDs to third-party broker-dealers, who in turn sell them to retail accounts. A CD-specific selling group agreement will typically be used to document the relationship between the brokers.

Marketing of Structured Certificates of Deposit

THE MARKETING PROCESS FOR STRUCTURED CERTIFICATES OF DEPOSIT

Issuing banks employ a similar marketing process for SCDs as they do in the offering of structured notes that are issued under a medium-term note program. Banks that are frequent issuers of SCDs will market SCDs with specific structures, linked to different reference assets. Further, as with medium-term notes, an issuing bank can tailor a SCD offering with characteristics that are unique to the market, in order to meet the needs of specific investors (also known as a "reverse inquiry").

STRUCTURED CERTIFICATES OF DEPOSIT AND HEDGING TRANSACTIONS

The issuing bank or its affiliates may engage in hedging transactions. An issuing bank will typically hedge to offset its payment obligations at maturity. This hedge transaction is typically arranged by the investment bank that is acting as broker for the SCDs.

Other Considerations for Structured Certificates of Deposit

STRUCTURED CERTIFICATES OF DEPOSIT AND TAX CONSEQUENCES

The specific U.S. federal tax consequences to an investor depend upon a variety of factors, particularly the structure of the SCD. These tax consequences are typically discussed in the SCD's offering documents. Because many SCDs are typically subject to contingent payments during the term of the instrument or at maturity, they often require the holder to include in income "original issue discount," even though the holder may or may not actually receive a cash payment prior to maturity.

SECONDARY TRADING MARKET FOR STRUCTURED CERTIFICATES OF DEPOSIT

There is not always a secondary trading market for SCDs. SCDs are generally not liquid investments since they are not typically traded on any exchanges. Further, issuing banks rarely create a secondary market for SCDs, and, even if a secondary market is created, such banks are under no obligation to maintain it. Market-making activities with respect to the SCDs are typically limited to buy-backs by the broker-dealers that originally offered them. As a result, if an investor decides to sell his or her SCD prior to maturity, the amount he or she receives could potentially be lower than the principal amount.

Checklist of Key Questions

- ✓ Will the certificate of deposit pay either interest payments or an additional payment at maturity based on the performance of a reference asset?
- ✓ What types of disclosure documents should be used in connection with the offer of the structured certificates of deposit?
- ✓ How will the structured certificates of deposit be marketed?
- ✓ Will the structured certificates of deposit be sold by the bank's affiliated broker-dealer?
- ✓ Will the affiliated broker-dealer enter into arrangements with third-party broker-dealers to distribute the structured certificates of deposit?
- ✓ Will there be a secondary market for the structured certificates of deposit?
- ✓ Will the structured certificates of deposit be repackaged?

WHAT'S THE DEAL? Trust Indenture Act

Here's the Deal:

- The Trust Indenture Act of 1939 regulates the offer and sale of certain debt securities.
- For offerings of registered debt securities, an indenture must be qualified under the Trust Indenture Act as a condition of effectiveness of the related registration statement.
- The form of indenture and the Form T-1 must be included in the registration statement at the time of effectiveness.
- The Trust Indenture Act requires certain prospectus disclosure about the debt securities in registered offerings.
- Most offerings of debt securities that are exempt from registration under the Securities Act of 1933 are also exempt from the Trust Indenture Act requirements.

What's the Deal?

Structured The Trust Indenture Act of 1939 (the "Trust Indenture Act" or the "TIA")[5] is the federal statute regulating the offer and sale of certain debt securities. The TIA, which is closely integrated with the Securities Act of 1933 (the "Securities Act"), protects certain rights of security holders, imposes minimum obligations on trustees and obligors and confers on trustees the powers and resources needed to meet obligations to investors. All of these provisions result from the process of indenture qualification.

In registered offerings, compliance with the TIA requirements is a condition to the Securities and Exchange Commission's (the "Commission" or "SEC") order of effectiveness for a Securities Act registration statement relating to debt securities. Certain offerings exempt from registration under the Securities Act are subject to the TIA's requirement of qualification.

As first enacted, the qualification process required the recitation of prescribed statutory terms within the indenture, the contract defining the rights of security holders. As amended in 1990, the TIA now creates the rights and duties originating in such terms directly through qualification. Even though these mandates become effective on qualification by operation of law, the universal practice remains to include the prescribed provisions in the text of qualified indentures.

Which Securities Are Covered by the TIA?

The TIA applies only to debt securities and interests in debt securities. (Interestingly, the terms "debt securities" and "equity securities" appear nowhere in the law.)

The TIA does not apply to stock. Section 304(a)(1) limits the statute's application to:

[5] 15 U.S.C.A. §§ 77aaa–77bbbb (2022).

- Any "note, bond, debenture, or evidence of indebtedness, whether or not secured";
- Any "certificate of interest or participation in" such debt securities; or
- Any "temporary certificate for, or guarantee of" such debt securities or certificates of interest.

Rights and Duties Created by Trust Indenture Qualification

Under Section 318(c) of the TIA, the following TIA provisions apply to every qualified indenture, whether or not recited in the indenture:

- Section 310 – Eligibility and disqualification of trustee;
- Section 311 – Preferential collection of claims against obligor;
- Section 312 – Bondholder's lists;
- Section 313 – Reports by indenture trustee;
- Section 314 – Reports by obligor; evidence of compliance with indenture provisions;
- Section 315 – Duties and responsibility of the trustee;
- Section 316 – Directions and waivers by bondholders; prohibition of impairment of holder's right to payment; and
- Section 317 -– Special powers of trustee; duties of paying agents.

If a provision of the indenture limits, qualifies or conflicts with the duties imposed by the TIA, the requirements of the TIA control,[6] which is to say that the TIA automatically invalidates contractual provisions removing or limiting mandatory terms.

Provisions Unregulated by the TIA

Business provisions of an indenture are unregulated. Section 318(b) of the TIA permits a qualified indenture to contain any provisions not in contravention of its terms, in addition to the provisions specifically authorized by the statute. The TIA imposes no controls on such things as interest rates, financial covenants, maturity dates or the definition of default.

Which Securities Are Exempt from Qualification?

Section 304 of the TIA exempts from qualification certain securities. These include:

- Securities issued in an amount of not more than $50 million during a 12-month period,[7] such as securities issued under Rule 504 under the Securities Act;
- Securities issued under Regulation A;[8]
- Securities issued under an indenture in an amount not exceeding $10 million at any time;[9]

6 TIA, Section 318(a).
7 TIA, Section 304(a)(8) and Rule 4a-1 under the TIA.
8 TIA, Section 304(d) and Rule 4a-2 under the TIA. Regulation A Tier 2 offerings are limited to $75 million. Securities Act Rule 251(a)(2).
9 TIA, Section 304(a)(9) and Rule 4a-3 under the TIA.

- Most securities exempt under Section 3(a) of the Securities Act, including government and bank securities exempt under Section 3(a)(2) and commercial paper exempt under Section 3(a)(3);[10]
- Securities issued by a foreign government;[11] and
- Guarantees of the above.[12]

A debt security issued under a bankruptcy plan that matures no later than one year after the effective date of the plan is not subject to the TIA.[13]

Which Transactions Are Exempt from the TIA?

The TIA exempts securities sold in transactions that are also exempt under Section 4 of the Securities Act. Thus, the exemptions for private placements, for offers and sales to accredited investors up to $10 million, and for sales under the crowdfunding exemption up to $5 million are incorporated into the TIA. Likewise, the Securities Act trading exemptions are also exempt from the qualification requirement, meaning that transactions under Sections 4(a)(1), 4(a)(3) and 4(a)(4) are outside the TIA. Finally, offers and sales pursuant to Section 4(a)(7), covering certain private resales, are not subject to TIA's qualification requirement. The sum result of these exemptions is that the qualification requirement of the TIA only applies to distributions by the issuer or for affiliates.

Exemptions by SEC Order

Section 304(d) authorizes the Commission to exempt from one or more of the provisions of the TIA, conditionally or unconditionally, any persons, registration statements, indentures, securities or transactions. Upon application by an interested person, exemptions may be made in individual cases by an SEC order. Upon the Commission's own motion, any exemptions may be granted through rules, subject to the customary public interest and investor protection standards.

Rules 4d-7 and 4d-8 under the TIA prescribe the procedures for an exemptive application under Section 304(d). Basically, an application must contain a statement of the relevant facts, including a justification for the exemption requested and a discussion of any benefit expected for security holders, trustees and/or obligors.

Regulation S, Rule 144A and the TIA

The TIA's provisions are directed at offerings in the United States. Regulation S recognizes that Securities Act registration requirements do not apply to offers and sales made exclusively outside the United States. Adopting the regulation, the SEC stated that it also would not take any enforcement action under the TIA if offers and sales are made offshore in compliance with the safe harbor provisions of Rule 903 or 904 without qualification.[14] Rule 144A offerings to qualified institutional buyers are also exempt from the TIA qualification requirements under Section 304(b) as transactions exempt from Securities Act registration

10 Section 304(a)(4) of the TIA.
11 Section 304(a)(6) of the TIA.
12 Section 304(a)(7) of the TIA.
13 11 U.S.C. Section 1145(d).
14 Offshore Offers and Sales, Securities Act Rel. No. 33-6863 (Apr. 24, 1990), C.C.H. Fed. Sec. L. Rep. ¶ 84,524, at p. 80, 682. *See also* TIA C&DI 201.01.

under Section 4. Because these debt securities are "restricted securities," as that term is defined in Securities Act Rule 144(a)(3), they generally may not be publicly resold upon issuance without registration.

What Are the Trustee Eligibility Requirements Under a Qualified Indenture?

Section 310(a) of the TIA provides that under every indenture that is qualified, or to be qualified, there must always be at least one institutional trustee that shall have a combined capital and surplus of at least $150,000.[15] The institutional trustee must be a corporation organized and doing business under the laws of the United States, of any state or territory, or of the District of Columbia. The institution must be authorized by those laws to exercise corporate trust powers and must be subject to supervision or examination by federal or state authority.[16] A subsidiary of a foreign company is eligible it is organized and doing business in the United States.[17]

What Are the TIA Qualification Procedures?

Registration under the Securities Act and qualification under the TIA are closely coordinated. Section 309(a)(1) of the TIA provides that the indenture will be deemed to have been qualified when the related Securities Act registration statement becomes effective. Along with the Securities Act registration statement, the obligor qualifying its debt securities must file with the Commission:

- A statement of eligibility and qualification of the indenture trustee, usually on Form T-1;[18]
- A copy of the indenture, including a table of contents;[19] and
- A cross-reference sheet showing the location in the indenture of the mandatory and permissive TIA provisions.[20]

In addition, the prospectus filed under the Securities Act must contain a description of the debt securities being registered and of the indenture.

Form T-1 is the form that qualifies the trustee under the indenture. Form T-1 is used by banks and trust corporations named as trustees. Section 310(a)(1) of the TIA requires that, if, as is typically the case, there is only one indenture trustee, it must be a corporation. Form T-1 must be filed as Exhibit 25 to a registration statement that includes a class of debt securities. The Form T-1 must have been filed when the registration statement for that class of debt securities becomes effective (TIA § 309(a)(1)).

If a single trustee will serve under two indentures being qualified with the same registration statement, only one Form T-1 needs to be filed. However, the cover page of the T-1 should state that there are two indentures.[21] Otherwise, if different classes of debt securities are represented by separate indentures, there should be a Form T-1 filing for each such class.[22]

15 TIA, Section 310(a)(2). Most indentures include a much higher capital requirement.
16 TIA, Section 310(a)(1).
17 Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations* ("TIA C&DI") 105.01.
18 TIA, Section 305(a)(1); TIA Rule 5a-1(a).
19 Regulation S-K Item 601(b)(4)(iv)(A).
20 Regulation S-K Item 601(b)(4)(iv)(B).
21 TIA C&DI 219.01.
22 TIA C&DI 101.04.

Timing of Qualifying Indentures – Forms S-3/F-3 Compared to S-3ASR/F-3ASR

For Forms S-3 or F-3, a class of debt securities cannot be added by means of a post-effective amendment. The Form T-1 must be included as an exhibit at the time that the registration statement becomes effective. The indenture cannot be qualified by means of a post-effective amendment.[23] The TIA does not contemplate post-effective amendments.

For automatic shelf registration statements (S-3ASR or F-3ASR), if a class of debt securities is included in the original registration statement filing, unless qualification for the trustee is deferred under Section 305(b)(2), the Form T-1 must generally be included as an exhibit to that filing. However, for ASRs, a class of debt securities can be added by means of a post-effective amendment. The ASR is effective as to the newly-added class of debt securities at the time of the filing of the post-effective amendment. Consequently, a Form T-1 must be filed as an exhibit to the post-effective amendment and will be effective for the new class of debt securities at the time of the filing.

A Form T-1 cannot be incorporated by reference into a new shelf registration statement from an issuer's previous shelf registration statement.[24] However, an existing previously filed indenture, or form of indenture, can be incorporated by reference into the new shelf registration statement.

If, at the time of effectiveness (original filing or post-effective amendment for ASR; original filing or pre-effective amendment for S-3/F-3), the indenture for a class of registered securities, or a form of indenture, and a matching Form T-1, are not included or incorporated by reference as an exhibit to the registration statement, there may be a 10-day delay in the offering.

Where Form T-1 is filed on a delayed basis in a shelf offering, it must be separately filed through EDGAR as form type "305B2," and not filed as a post-effective amendment to the registration statement or on a Form 8-K incorporated by reference into the registration statement.[25] Filing Form T-1 under form type 305B2 should be avoided, as Form T-1 will become effective ten calendar days after the filing unless acceleration is requested.[26] This delay runs counter to the purpose of shelf registration statements, which is to give the issuer the ability to quickly take advantage of market conditions. A post-effective amendment or Form 8-K will not work in this situation.[27, 28]

An indenture filed with most shelf registration statements is generally open ended, meaning it may provide a generic, non-specific description of the securities, such as "unsecured debentures, notes or other evidences of indebtedness," which are to be issued in series.[29]

23 SEC Release 33-8591 at n. 527, TIA C&DI 201.02.
24 TIA C&DI 108.02.
25 Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 206.01, 220.01 (Mar. 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.
26 TIA C&DI 103.01.
27 TIA C&DI 206.01.
28 In the unusual situation where an individual trustee is acting as a co-trustee with an institutional trustee, a Form T-2 would be used to qualify the individual trustee.
29 TIA C&DI 201.04.

What Are the Requirements of Form T-1?

Form T-1 calls for disclosures relating to the following:

- Item 1 – General information;
- Item 2 – Affiliations with the obligor;
- Item 3 – Voting securities of the trustee;
- Item 4 – Trusteeships under other indentures;
- Item 5 – Interlocking directorates and similar relationships with the obligor or underwriters;
- Item 6 – Voting securities of the trustee owned by the obligor or its officials;
- Item 7 – Voting securities of the trustee owned by underwriters or their officials;
- Item 8 – Securities of the obligor owned or held by the trustee;
- Item 9 – Securities of underwriters owned or held by the trustee;
- Item 10 – Ownership or holdings by the trustee of voting securities of certain affiliates or security holders of the obligor;
- Item 11 – Ownership or holdings by the trustee of any securities of a person owning 50 percent or more of the voting securities of the obligor;
- Item 12 Indebtedness of the obligor to the trustee;
- Item 13 – Defaults by the obligor;
- Item 14 – Affiliations with the underwriters;
- Item 15 – Foreign trustee; and
- Item 16 – List of exhibits.

If the obligor is not in default, the applicant need only provide the information required by Items 1, 2, 15 and 16, where applicable.

When Are Forms T-3 and T-6 Used?

When no Securities Act registration statement is to be filed, such as in the case of exchange offers exempt under Section 3(a)(9), TIA Section 307(a) prescribes the procedures for qualification of the indenture. The application for qualification of the indenture must be filed by the issuer on Form T-3. The trustee's statement of eligibility and qualification, generally filed on Form T-1, must also be separately filed, as well as all other items required under Section 305(a) for qualification when a Securities Act registration statement is required. Form T-3 is to be signed on behalf of the issuer by a duly authorized person.

Form T-3 requires disclosure regarding:

- The issuer's form of organization and the state under whose laws it is organized;
- A list or diagram of the issuer's "affiliates";[30]
- A list of directors, executive officers and principal (10% or more) shareholders;
- Names and addresses of past and prospective underwriters;
- A table showing the issuer's capital structure and amounts of each class of securities authorized and outstanding;
- An analysis of certain indenture provisions, as required by Section 305(a)(2);
- The name and address of other obligors on the indenture securities; and
- Various exhibits, including the indenture and a cross reference sheet from it to the TIA's provisions, any prospectus sent to security holders, the issuer's charter and bylaws, and the relevant court or administrative order where an exemption from Securities Act registration has been claimed under Securities Act Section 3(a)(10). Offering materials that are required to be filed as an exhibit may be filed in definitive form when acceleration of the Form T-3 is requested.[31]

Required Prospectus Disclosure Under the TIA and Regulation S-K

Section 305(a)(2) of the TIA requires the issuer to include in the registration statement an analysis of a number of indenture provisions. However, Item 202 of Regulation S-K supersedes Section 305(a)(2) in part. Instruction 3 to the item states, in part: "Section 305(a)(2) of the TIA … shall not be deemed to require the inclusion in a registration statement or in a prospectus of any information not required by this Item." The regulatory modification means that a description of debt securities conforming to Item 202 satisfies the disclosure requirements of the Securities Act and the TIA, including Section 305(a)(2). An additional incentive to comply with Section 305(a)(2) of the TIA in an underwritten offering of debt securities is that the underwriting agreement includes an issuer representation that the prospectus complies as to form with the Securities Act and the TIA.

Supplemental Indentures – When Is Qualification Required Under the TIA?

Supplemental indentures are generally entered into when an issuer offers a new series of debt securities pursuant to an open-ended indenture, with the debt securities being registered on a shelf registration statement. Supplemental indentures may also be used to make changes to the rights of debt security holders. Supplemental indentures to a qualified indenture normally do not need to be separately qualified; however, there are a few situations where such qualification is required:

- Supplemental indentures modifying terms of securities outstanding under previously qualified indentures making changes so significant that they are deemed to involve the offering of a new security and, therefore, the obligor either registers the transaction under the Securities Act or relies upon a Securities Act exemption for which there is no corresponding TIA exemption.

[30] As defined in TIA Rule 0-2(b).
[31] TIA C&DI 201.05.

- o If the modifications do not result in the offering of a new security and the offering is ongoing, the supplemental indenture may be filed as an exhibit to a Form 8-K if the offering is on Form S-3 (in the same manner as specified for underwriting agreements) or in an automatically effective, exhibit only post-effective amendment filed pursuant to Rule 462(d). For automatic shelf registration statements, the post-effective amendment would be filed pursuant to Rule 462(e). If the offering has terminated, the amended indenture should be filed as Exhibit 4 to the company's next report required to be filed under the Securities Exchange Act of 1934 (the "Exchange Act").[32]

- A supplemental indenture providing for the substitution of a new obligor need not be qualified under the TIA if the substitution takes place pursuant to a provision of the old indenture and is not subject to the approval or consent of security holders. If approval by debt holders must be solicited, the sale of a new security is deemed to occur and therefore, a Securities Act registration statement should be filed and the indenture under which the new security is to be issued must be qualified.[33]

The SEC requires that all qualified indentures contain a provision that any supplemental indenture will comply with the provisions of the TIA.[34]

What Are the Duties of an Obligor Under a Qualified Indenture?

The TIA imposes upon each obligor duties to security holders and to the indenture trustee:

Bondholder lists. Section 312(a) requires each obligor to furnish current bondholder lists to the trustee. At stated intervals of not more than six months, and at such other times as the trustee may request in writing, each obligor is required to furnish or cause to be furnished to the trustee all information possessed by itself and its paying agents as to the names and addresses of the security holders. Customarily, indentures peg the date for furnishing bondholder lists to the semi-annual interest payment dates.

Copies of Exchange Act reports. Under Section 314(a)(1) of the TIA, each obligor must file with the trustee copies of all reports required by Section 13 or Section 15(d) of the Exchange Act. Sometimes indentures call for the reports to be sent to the trustee within 15 days after they are required to be filed with the Commission. Other indentures call for the reports to be sent to the trustee within 15 days after they are actually filed with the Commission. Many indentures include a provision whereby the issuer's Exchange Act periodic reports will be deemed delivered to the trustee and the holders under the indenture at the same time as these are filed with the Commission.

Courts have held that Section 314(a)(1) does not impose an independent obligation that Exchange Act periodic reports be filed on time. The section merely requires that the obligor file with the trustee those reports that it has in fact filed with the Commission. Thus failure to file a timely annual report on Form 10-K, quarterly report on Form 10-Q or current report on Form 8-K is not a breach of the TIA or of an

[32] See TIA C&DI 102.01
[33] TIA C&DI 101.03.
[34] SEC Manual – Trust Indenture Act of 1939 at p. 157 (June 1958).

indenture covenant that generally requires compliance with the TIA. It is only a breach of a covenant if the indenture language sets a time frame for filing or transmission of periodic reports to the trustee.[35]

Compliance certificate. Section 314(a)(4) requires each obligor to furnish the trustee at least annually a certificate regarding the obligor's compliance with all conditions and covenants under the indenture. A brief certificate from the obligor's principal executive officer, principal financial officer or principal accounting officer as to his or her knowledge of the obligor's compliance satisfies the requirement. Compliance is to be determined without regard to any grace period or notice requirement provided under the indenture, the same manner in which default is determined for purposes of triggering the conflict of interest provisions under Section 310(b) of the TIA.

Conditions precedent to request for action by the trustee. Under Section 314(c), whenever the obligor requests the trustee to take any action under the indenture, such as authenticating and delivering securities, releasing or substituting (or both) mortgaged property, or satisfying and discharging securities, the obligor must furnish the trustee with evidence that all relevant conditions precedent have been met. The evidence, detailed by Section 314(c), must consist of both a certificate by officers specified in the indenture and an opinion of counsel (who may be counsel for the obligor). In some situations, an accountant's certificate must also be furnished.

Section 314(e) specifies the form that opinions relating to any indenture covenant or condition must take. Each certificate or opinion must include a statement that the person making it has read the relevant covenant or condition. It must contain a brief statement as to the nature and scope of the examination or investigation on which the person's statements or opinions are based. It must recite that, in the opinion of the person making the certificate, he has made an examination or investigation that is adequate to permit him to express an informed opinion. Finally, the certificate must indicate whether or not, in the opinion of such person, there has been compliance with the relevant condition or covenant.

What Are the Duties of a Trustee Prior to a Default?

The TIA imposes certain minimal duties on the indenture trustee prior to any default by the obligor. The trustee must provide annual reports and periodic reports on certain developments to indenture security holders and to give notice to the security holders of all defaults known to the trustee within ninety days of their occurrence. Unless provided to the contrary in the indenture, the trustee's liability is limited to the performance of the duties specified in the indenture. Section 313 requires the trustee to:

- Transmit annual reports and periodic reports on certain developments to the indenture security holders;
- File a copy of each report with every exchange on which the securities are listed; and
- File a copy of each report with the Commission.

[35] *Affiliated Computer Servs. Inc. v. Wilmington Trust Co.*, 565 F.3d 924 (5th Cir. 2009); *UnitedHealth Group, Inc. v. Wilmington Trust*, 548 F.3d 1124 (8th Cir., 2008); *American Stock Transfer & Trust Co. v. Par Pharmaceutical Companies*, 2009 U.S. Dist. LEXIS 52602 (SDNY, June 19, 2009); *Finisar Corp. v. U.S. Bank Trust National Assoc.*, 2008 U.S. Dist. LEXIS 65329 (ND CA, Aug. 25, 2008); *Cyberonics, Inc. v. Wells Fargo Bank National Association*, 2007 U.S. Dist. LEXIS 42779 (SD TX, June 13, 2007).

The annual report is required in any of the following circumstances:

- Any change in the trustee's continuing eligibility and qualification under Section 310;
- The creation of, or any material change in, a relationship that, under Section 310(b), would constitute a conflict of interest after default by the obligor on the indenture securities;
- The character and amount of any advances the trustee has made that may result in a claim by the trustee prior to the claims of the indenture security holders on property or funds held by the trustee, if the amount of such advances remaining unpaid equals more than 0.5% of the indenture securities outstanding;
- The principal, interest rate, maturity date and collateral for all other amounts owed to the trustee on the date of the report by the obligor on the indenture securities, subject to certain exceptions;
- Any changes in the property and funds physically in the trustee's possession;
- Any change to any release, or release and substitution, of property subject to the lien of the indenture, not previously reported;
- Any additional issue of securities not previously reported; and
- Any other action taken by the trustee in performing its duties under the indenture that it has not previously reported, which in its opinion is material, except any action concerning a default, the notice of which has been or is to be withheld under an indenture provision authorized by Section 315(b) of the TIA.

Section 313(c) prescribes the required manner of transmitting reports to the security holders. The reports must be mailed to all registered holders who have, within the past two years, filed their names and addresses with the trustee for that purpose. The annual reports must also be mailed to everyone on the bondholders list furnished to the trustee pursuant to Section 312(a). Because Section 313(c) specifically requires these reports to be transmitted by mail, the Commission's policies on electronic delivery of documents to investors do not apply.

If the indenture securities are listed on the New York Stock Exchange, the NYSE requires the issuer to instruct the trustee to give immediate notice to the exchange of:

- Any change or removal of deposited collateral;
- Acceleration of maturity by the trustee;
- Issuance or authentication of duplicate bonds;
- Cancellation, retirement or other reduction in the amount of bonds outstanding; and
- Any call for redemptions, including sinking fund requirements.[36]

The issuer of notes listed on the NYSE must give the NYSE at least five business days' notice of any change of a trustee for such notes.

[36] NYSE Listed Company Manual, Sec. 603.02 (June 1983).

What Are the Duties of a Trustee After a Default?

The TIA imposes an enhanced duty of care and skill on trustees after default and gives trustees adequate powers to carry out their duties. Section 315(c) provides that the trustee, in case of default (as defined in the indenture), must exercise the rights and powers vested in it by the indenture and must use the same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

The trustee's enhanced duties are triggered only by a default as defined in the indenture. Thus, where the indenture defines an event of default as occurring only upon notice and the running of a grace period, the enhanced duty is not imposed before those conditions occur. Also, as permitted by the Commission, indentures usually provide that the trustee remains under this enhanced duty only while the event of default continues. Once the event of default is cured or waived, the trustee may act as in the pre-default period. For the trustee to effectively protect indenture security holders, it must have authority to pursue on their behalf claims against the obligor. Section 317(a) assures that the trustee has sufficient enforcement powers.

Section 317(a)(2) of the TIA authorizes the trustee, both before and after default, to file proofs of claim and other papers in connection with claims by the trustee or bondholders in any judicial proceeding relating to the obligor, its creditors or its property. This provision is necessary to assure that courts will not take the position that only the security holders themselves have the right to file claims. Section 317(a)(1) gives the trustee authority to recover judgment in its own name as trustee of an express trust against the obligor in case of default in payment of principal when due or, in case of a default in payment of interest, after any grace period provided by the indenture. Again, this provision is necessary to assure that courts will not require suits for payment to be brought only by the security holders directly.

What Are the Post-Default Obligations of a Trustee-Creditor?

Subject to certain exceptions, Section 311 of the TIA requires that, if the indenture trustee is or becomes a creditor of the obligor within three months prior to, or after, a failure by the obligor to pay principal or interest as it becomes due, then unless and until the default is cured, the trustee must set aside in a special account for the benefit of both the trustee individually and the security holders various amounts received by the trustee. The three-month period runs from the date of non-payment of principal or interest, even if the indenture otherwise provides a grace period before non-payment becomes an event of default.

If the trustee is required to account to the security holders, the funds and property held by the trustee in the special account must be apportioned so that the trustee and the security holders realize the same percentage of their respective claims. The amounts which the trustee must hold in the special account are:

- All reductions in indebtedness effected after the beginning of the three-month period that are valid against the obligor and its other creditors;[37] and

[37] TIA, Section 311(a)(1).

- All property received after the start of the three-month period as:
  - Security for the trustee's claim;
  - In satisfaction or settlement of the claim, or otherwise as to the claim;[38] or
  - Any proceeds from the sale of such property.[39]

Are There Trustee Conflicts of Interest that May Result in Disqualification?

Section 310(b) of the TIA lists prohibited conflicts of interest of a trustee. If a default has occurred, the trustee must, within 90 days after it ascertains that it has a prohibited conflict of interest, either eliminate the conflict or resign. The prohibited conflicts of interest are:

- Such trustee is trustee under another indenture under which any other securities, or certificates of interest or participation in any other securities, of an obligor upon the indenture securities are outstanding;
- Such trustee or any of its directors or executive officers is an underwriter for an obligor under the securities;
- Such trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with an underwriter for an obligor under the securities;
- Such trustee or any of its directors or executive officers is a director, officer, partner, employee, appointee or representative of an obligor under the securities or of an underwriter for such an obligor who is currently engaged in the business of underwriting;
- At least 10% of the voting securities of such trustee is beneficially owned either by an obligor under the securities or by any director, partner or executive officer of the obligor;
- At least 20% of the voting securities of such trustee is beneficially owned, collectively, by any two or more obligors under the securities or any director, partner or executive officer of the obligor;
- At least 10% of the voting securities of a trustee is beneficially owned either by an underwriter for any such obligor or by any director, partner or executive officer of the obligor or is beneficially owned, collectively, by any two or more such persons;
- The trustee is the beneficial owner of, or holds as collateral security for an obligation of, an obligation that is in default; or
- Unless expressly permitted under Section 311(b) of the TIA, the trustee is (or becomes) a creditor of the obligor.

A trustee's resignation is effective upon appointment of a successor and the successor's acceptance of appointment. Pursuant to Section 310(b) of the TIA, the obligor must take prompt steps to have a successor appointed.

If the trustee fails to resign, it must notify the security holders of this within ten days after the expiration of the 90-day resignation period in the manner and to the extent provided in Section 313(c) of the TIA.

[38] TIA, Section 311(a)(2).
[39] TIA, Section 311(a)(2).

Finally, any person who has owned the securities for at least six months may petition a court for removal of a trustee that has not eliminated a prohibited conflict of interest and for appointment of its successor if the trustee has not submitted its required resignation after the security holder has requested it in writing.

Dual Trusteeships

Trustees may be prohibited from serving as the trustee under more than one of an issuer's indentures. This does not apply where the securities are not of the same class (*i.e.*, an issuer can have the same trustee for senior and subordinated indenture securities). Similarly, the same trustee can be the trustee on the issuer's and its subsidiary's securities, provided that neither the parent or the subsidiary are guaranteeing the other entity's securities.[40]

Trustee Affiliations with Underwriters

Section 310(b)(2) of the TIA prohibits the trustee or any of its directors or executive officers from being an underwriter for the obligor. This prohibition is not limited to an underwriter for the indenture securities but also extends to any person who, within the prior one-year period, was an underwriter of any security of the obligor still outstanding when the determination of underwriter status is made.

The term "underwriter" is defined more narrowly in one respect under the TIA than in the Securities Act. Unlike Securities Act Section 2(a)(11), TIA Section 303(4) does not include persons involved in a distribution on behalf of affiliates of the issuer in the definition of "underwriter." Section 310(a)(5), however, as a condition of eligibility separately prohibits the trustee from being an affiliate of the issuer.

Drafters of prospectuses for offerings of registered debt securities should disclose, in the section on the description of the debt securities that discusses the trustee, any existing Section 310(b) conflicts of interest that may cause the trustee to resign. These normally include dual trusteeships, underwriter affiliations and the trustee being a creditor of the issuer.

Trustee as Creditor of Issuer

Under Section 310(b) of the TIA, a conflict of interest exists if, after a default, the trustee is or becomes a creditor of the issuer. A common cause of this creditor relationship may be the issuer having drawn on the trustee's credit facility. Debt securities issued under an indenture are excluded from this potential conflict of interest under Section 310(b)(10) and Section 311(b)(1).

How Can Bondholders Enforce Indenture Provisions?

The TIA provides for direct action to be taken by the security holders to enforce their rights, such as requirements that facilitate communications between bondholders and guarantee the bondholder's right to sue for principal and interest, and permissive provisions that authorize bondholders to postpone interest payments, waive past defaults, direct the trustee in conducting remedial proceedings, and remove the trustee. The TIA also includes protective provisions to prevent small numbers of bondholders from acting contrary to the best interests of bondholders in general.

[40] See TIA C&DI 106.01.

Section 312(b) contains provisions that facilitate communications among security holders. Under Section 312(b), certain action must be taken by the institutional trustee after it receives a written application from three or more security holders stating that they desire to communicate with other indenture security holders as to their rights. The security holders' application must be accompanied by a copy of the proxy or other communication that they propose to transmit to other bondholders. It must also be accompanied by reasonable proof that each applicant has owned a security for at least six months prior to the application.

When the institutional trustee receives this application, within five business days it must (at the trustee's election) either afford the applicants access to the security holder lists that it is required to maintain under the provisions of Section 312(a) or furnish information that will lead to the trustee's mailing of the communication to the indenture security holders.

If the trustee chooses to mail the communication, it must, within the five business-day period, inform the applicants of the approximate number of security holders and the approximate cost of mailing the proposed communication to them. Then, if the applicants furnish the trustee the material to be mailed and make or provide for payment of the reasonable expenses of mailing, the trustee must mail the material with reasonable promptness to all security holders on the list in its possession.

If the trustee believes that the requested mailing would be contrary to the best interests of the security holders, or would be in violation of law, Section 312(b) permits the trustee to temporarily delay mailing and seek a ruling by the Commission. Within five days after the tender by the applicant bondholders of the communication that they desire the trustee to mail, the trustee may mail to the applicants and file with the Commission a written statement specifying the basis of its opinion as to why the mailing would be contrary to the security holders' best interests or in violation of law. After an opportunity for hearing, the Commission may, and, if demanded by the trustee or applicants must, enter an order either sustaining or refusing to sustain the trustee's objections. The trustee must mail the material only if the Commission refuses to sustain its objections or if, after sustaining its objections, the Commission later, after notice and opportunity for hearing, finds that the applicants have met the objections.

Communications by bondholders pursuant to the provisions of Section 312(b) may be subject to the Commission's proxy rules under Exchange Act Section 14 if the class of securities is registered under Section 12 of the statute. Section 12 registration is required for any exchange-listed security and to any equity security, which includes debt securities convertible into equity securities, where the issuer's assets exceed $10 and record holders of the class equal at least 500 unaccredited investors or 2,000 persons in all.[41] Section 12 registration subjects the issuer to the Exchange Act's proxy rules in respect of the registered class,[42] which include fraud prohibitions and certain filing requirements.[43]

[41] Exchange Act Section 12(g) and Rule 12g-1. Section 12(g) of the Exchange Act and Rule 12g-1 require registration of equity securities if the issuer has total assets exceeding $10 million and the class of the equity securities is held of record by either 2,000 persons or 500 persons who are not accredited investors. "Person" is defined in Section 3(a)(9) of the Exchange Act and "accredited investor" is defined in Securities Act Rule 501(a). Convertible debt is defined as an equity security for these purposes, Exchange Act Section 3(a)(11).

[42] Exchange Act Section 14 and Rules 14a-1 to 14a-12.

[43] Exchange Act Rule 14a-3(a); Rule 14a-16.

Right To Sue for Principal and Interest

Section 316(b) guarantees certain rights to each security holder. The rights of any bondholder to receive principal and interest, or to institute suit for their enforcement, on or after the due dates expressed in the indenture security must not be impaired or affected without the consent of the holder. However, a limited postponement of interest, effected in accordance with Section 316(a)(2), is permitted. In 2022, Section 316(b) was amended to clarify that, in the context of indenture securities for which the rate of interest changes from U.S. dollar LIBOR to CME Term SOFR after June 30, 2023 under Section 104 of the Adjustable Interest Rate (LIBOR) Act, "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security shall not be deemed to be impaired or affected by any change occurring by the application of section 104 of the Adjustable Interest Rate (LIBOR) Act to any indenture security."

Postponement of Interest and Waiver of Past Defaults by Vote of Bondholders

Section 316(a)(2) permits the indenture to contain provisions authorizing the holders of at least 75% in principal amount of the outstanding indenture securities, or of any outstanding series of securities, to consent to the postponement of any interest payment for a period not exceeding three years from its due date. In computing the requisite 75% vote, securities owned by any obligor or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with any obligor are to be disregarded. In this way, voting by persons with clear conflicting interests is avoided.

Subject to contrary provisions in the indenture, Section 316(a)(1)(B) permits holders of not less than a majority in principal amount of the outstanding indenture securities to consent on behalf of all holders to the waiver of any past default and its consequences. The indenture may permit a majority of any outstanding series of securities to similarly consent to the waiver of past defaults and their consequences on behalf of all holders of the series.[44] In computing the votes needed, securities owned by obligors or their affiliates are disregarded in the identical manner as in voting on interest postponements. The majority's power to waive past defaults is subject to the overriding provision of Section 316(b) assuring each bondholder the right to receive or sue for principal and interest after their respective due dates.

Solicitation of bondholders to consent to interest postponements or waivers of default may be subject to the Commission's proxy rules if the bonds are listed on an exchange or where convertible debentures are involved.

Section 316(c) permits the obligor to set a record date for purposes of determining the security holders entitled to vote on the postponement of interest or the waiver of past defaults. Unless the indenture provides otherwise, the record date is to be the later of (1) thirty days before the first solicitation of security holders or (2) the date prior to the first solicitation when the most recent list of holders was furnished to the trustee pursuant to Section 312.

Are There Private Rights of Action for Misstatements or Omissions Under the TIA?

Section 323(a) of the TIA creates a private right of action for damages. Any person (including an issuer or a trustee) who makes, or causes to be made, a materially false or misleading statement, or who omits any

[44] "Series" is defined by Section 310(b).

material fact, in any TIA application, report or document filed with the Commission, is liable to any person who, not knowing of the untruth or omission, in reliance on it purchases or sells a security issued under the indenture to which the application, report or document relates. TIA Rule 0-11 provides a safe harbor for certain forward-looking statements made with a reasonable basis and disclosed in good faith. Section 323(b) provides that the rights and remedies provided by the TIA shall be in addition to any and all other rights and remedies that may exist under the Securities Act or the Exchange Act or otherwise at law or in equity. However, the recovery is limited to actual damages.

Trustee Liability

The trustee which fails to carry out its obligations under a qualified indenture may be liable to injured bondholders under state law breach of fiduciary duty or breach of contract claims or under Section 323(a) the TIA.

Sections 315(d)(2) and (3) of the TIA protects trustees from liability from (i) any good faith errors of judgment made by its own responsible officers, unless it is proven that the trustee was negligent in ascertaining the pertinent facts and (ii) following the directions of holders of a majority of the securities.

A qualified indenture may not include an exculpatory clause. Section 315(d) forbids the inclusion of any provisions relieving the trustee from liability for its own negligent action, its own negligent failure to act or its own wilful misconduct, subject to certain exceptions.

Jurisdiction and venue for suits involving trustee liability are governed by Section 322(b) of the TIA, which provides that "jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability or duty created by, this title, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in [S]ection 22(a) of the Securities Act …." The nationwide service of process provisions in Section 22(a) confer personal jurisdiction over defendants in all federal district courts.

Court Costs and Fees

Where security holders may bring a direct action to enforce indenture provisions, Section 315(e) deems automatically included in the indenture, unless expressly excluded by language in the indenture, the security holders' agreement to the court imposing on them an undertaking to pay costs. This permits the court, in its discretion, to assess reasonable costs, including reasonable attorney's fees, having due regard for the merits and good faith of the claims or defenses made by the litigant. This provision calling for an undertaking for costs, however, may not apply to a suit instituted by any security holder, or group of holders, who hold in the aggregate more than 10% of the securities outstanding, nor may it apply to a suit by any bondholder for payment of principal or interest, on or after their respective due dates.

Trustee Indemnification

In recent years, trustees have expanded their indemnity provisions in the indenture. Generally, the trustee will seek indemnity from the issuer for the trustee's acceptance of the administration of the indenture and the performance by the trustee of its duties. The trustee will seek to have the indemnity provision cover any losses, damages, claims, liabilities or expenses, such as attorneys' fees, incurred by the trustee.

The trustee will also seek to include provisions whereby the issuer will defend any claim made against the trustee in connection with the administration of the indenture. The issuer will also be responsible for the fees of trustee's counsel hired in connection with any claim made against the trustee, subject to certain exceptions.

Recent Attempts To Use Section 316(b) To Prevent Out-of-Court Restructurings

The interpretative battle over the question whether Section 316(b) protects a debt holder's legal right to payment as opposed to the practical ability to recover reached a head in *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp.*[45] Marblegate focused on whether Section 316(b) provides narrow protection against a majority amendment of certain "core terms" as opposed to providing broad protection for holders against nonconsensual debt restructurings.

Education Management LLC ("EDM") had approximately $1.5 billion of debt outstanding, of which $1.3 billion was secured debt under a credit agreement and $217 million were unsecured notes. The notes were guaranteed by Education Management Corp. ("EDMC"), EDM's parent (the "Parent guarantee"). The indenture provided that the Parent guarantee can be released if a majority of bondholders consented or if the secured lenders released EDMC's guarantee of the secured credit agreement. The indenture was qualified under the TIA, so Section 316(b) applied.

In May 2014, EDMC was in financial distress and needed to restructure. Bankruptcy restructuring was not a viable option. EDMC negotiated a restructuring agreement with an *ad hoc* group of creditors (who held about 80.6% of the secured debt and 80.7% of the unsecured notes) and came up with two options.

Option 1, a restructuring, required unanimous creditor support. Under Option 1, $150 million of revolving loans would be repaid. The remainder, $1.1 billion of secured debt, would be exchanged for $400 million in new term loans and preferred stock convertible into 77% of EDC common stock (resulting in a 54.6% recovery). Bondholders would receive equity convertible into 19% to 23% of common stock (resulting in a 32.7% recovery). The current shareholders would receive 4% of the EDMC common stock.

Under Option 2, an intercompany sale, majority creditor support would be required. The secured lenders would release the guarantee of the credit agreement, triggering release of the Parent Guarantee; foreclose on substantially all of the assets of EDMC and subsidiaries; and convey the foreclosed assets back to a new subsidiary of EDMC, which would distribute new debt and equity to consenting holders.

The non-consenting holders would receive no distribution. They would retain their notes without modification. The non-consenting holders would still have a claim against the original issuer (now without any assets because of the foreclosure and asset transfer) and without any claim against EDMC (because of the parent guarantee release).

All of EDMC's creditors agreed to Option 2 in the exchange offer, except for Marblegate, which sought a preliminary injunction to block the intercompany sale. In *Marblegate Asset Mgmt. v. Educ. Mgmt Corp.*[46] ("Marblegate I"), Marblegate, the sole holdout, sued to enjoin the intercompany sale claiming that it violated Section 316(b). The district court denied the plaintiff's motion for a preliminary injunction. But, the plaintiffs demonstrated a likelihood of success on the merits that the intercompany sale would violate

[45] 846 F.3d 1 (2d Cir. 2016).
[46] 75 F. Supp. 3d. 592 (S.D.N.Y. 2014).

Section 316(b). The district court stated that "[p]ractical and formal modifications of indentures that do not explicitly alter a core term 'impair or affect' a bondholder's right to receive payment in violation of the TIA only when such modifications effect an involuntary debt restructuring."

The intercompany sale occurred, the foreclosure sale took place, the new EDMC subsidiary was capitalized with EDMC's old assets, and consenting bondholders participated in the debt for equity exchange. Marblegate continued to hold out and the parties went back to court to decide whether the release of the parent guarantee should be permanently enjoined. In *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*[47] ("Marblegate II"), the district court decided that the release of the parent guarantee would violate Section 316(b). The question before the court was "does a debt restructuring violate Section 316(b) of the TIA when it does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date, yet leaves the bondholders no choice but to accept a modification of the terms of their bonds? Examining the text, history, and purpose of the TIA, the Court concluded that the answer is yes." The court held that an out-of-court restructuring that involved the elimination of a parent guarantee and a significant asset transfer was impermissible under Section 316(b). An appeal to the Second Circuit followed.

The Second Circuit, in *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp.*[48] ("Marblegate III"), vacated Marblegate II and rejected the district court's broad reading of Section 316(b). The Second Circuit concluded that Section 316(b) only prohibits "non-consensual amendments to an indenture's core payment terms" and not the practical ability to receive payment. The "core terms" were characterized as the principal and interest owed and the maturity.[49] The court stated that "the core disagreement in this case is whether the phrase 'right … to receive payment' forecloses more than formal amendments to payment terms that eliminate the right to sue for payment."[50]

Although the court noted that the text of Section 316(b) is ambiguous and lends itself to multiple interpretations,[51] the court refused to adopt Marblegate's broad reading of the term "right" in Section 316(b), because including the practical ability to collect payment "leads to both improbable results and interpretative problems."[52] "[I]nterpreting 'impaired or affected' to mean any *possible* effect would transform a single provision of the TIA into a broad prohibition on any conduct that could influence the value of a note or a bondholder's practical ability to collect payment."[53]

In *CNH Diversified Opportunities Master Account, L.P. v. Cleveland Unlimited, Inc.,*[54] pursuant to an out-of-court bond restructuring, plaintiff minority bondholders sought payment on their notes after the trustee, at the direction of the majority bondholders, "strictly foreclosed" and purported to cancel the plaintiffs' notes. The plaintiff bondholders had not consented to the strict foreclosure and sued, based on Section 6.07 of the indenture provision, which tracked Section 316(b) of the TIA. Plaintiffs argued that their rights to payment and interest, and their right to bring suit to enforce those payment rights, had been

47 111 F. Supp. 3d 542 (S.D.N.Y. 2015).
48 846 F.3d 1 (2d Cir. 2017).
49 846 F.3d 1, 7.
50 846 F.3d 1, 6.
51 846 F.3d 1, 6.
52 846 F.3d 1, 7.
53 846 F.3d 1, 7.
54 2020 WL 6163305 (N.Y. Oct. 22, 2020)

terminated without their consent.[55] Under *Marblegate*, according to the plaintiffs, the strict foreclosure could not be used to extinguish their rights to sue the issuer.

The New York court noted the Second Circuit's rejection of the argument that Section 316(b) protects a bondholder's "practical ability" to recover payment in full. The court distinguished the plaintiffs' argument in *Marblegate* from the plaintiffs' argument in *CNH Diversified*: here, the strict foreclosure had the effect of cancelling the plaintiffs' bonds, terminating their legal right to receive payment of principal and interest on the notes.[56] Consequently, based on the *Marblegate* court's analysis of Section 316(b) of the TIA, the court held that the purported cancellation of plaintiffs' notes without their consent violated Section 6.07 of the indenture.[57]

Directions to Trustee by Bondholders

Subject to contrary provisions in the indenture, Section 316(a)(1)(A) of the TIA permits the holders of not less than a majority in principal amount of the outstanding securities to direct the time, method and place of conducting any proceeding for any remedy available to the trustee under the indenture or exercising any trust or power conferred on the trustee under the indenture. Under Section 315(d)(3), unless the indenture provides to the contrary, the trustee is protected as to any action taken or omitted in good faith in accordance with the direction of bondholders so given.

In determining under Section 316(a)(1)(A) whether the requisite majority has given directions, securities owned by any obligor, or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with the obligor, are to be disregarded. In determining whether the trustee is protected by Section 315(d)(3), only securities that the trustee knows are owned by the obligor or affiliates need to be disregarded in determining if a requisite majority of bondholders has given directions.

Section 316(a)(1)(A) permits the indenture to provide for directions to be given by a majority vote of any outstanding series of securities. For this purpose, "series" is defined by Section 310(b) to mean any group of securities whose terms permit holders to vote separately to direct the indenture trustee or to otherwise take action pursuant to a separate vote. However securities that rank equally and are wholly unsecured may not be treated as separate series.

Canadian Issuers and the TIA

Rule 4d-9 exempts from many of the TIA's requirements indentures of issuers subject to these Canadian statutes if the securities are registered under the Securities Act on Form F-7, F-8, F-9, F-10 or F-80.[58] However, Sections 310(a)(1), (2) and (5) of the TIA, which set the eligibility criteria for institutional trustees, continue to apply to such indentures. So does Section 316(b), which prohibits impairment, without the security holder's consent, of the right to receive payment of principal and interest when due and to institute suit to enforce such payment.

55 *Id*. at 4.
56 *Id*. at 8.
57 Although the indenture at issue in *CNH Diversified* was not qualified under the TIA, it "incorporated by reference '[a]ny provision of the TIA which is required to be included in a qualified indenture.'" *Id*. at 1.
58 Effective December 31, 2012, Form F-9 was removed by the Commission. Securities Act Release 33-9245 (July 27, 2011). Rule 4d-9, however, was not updated.

The Commission adopted Rule 4d-9 as part of its multijurisdictional disclosure system for cross-border offerings by certain Canadian issuers.[59] The Canada Business Corporations Act, which governs indentures of federally chartered corporations; the Bank Act, which governs indentures for debt securities issued by Canadian banks; the British Columbia Company Act of 1979, which covers indentures of companies incorporated under British Columbia Law; and the Business Corporations Act, 1982 (Ontario), which governs all trust indentures used in connection with debt offerings made by prospectus in Ontario regardless of the law under.

Canadian Trusteeships

TIA Rule 10a-5 covers Canadian indenture securities registered under the Securities Act on Form F-7, F-8, F-9, F-10 or F-80.[60] The rule permits trust companies incorporated and regulated under Canadian laws, including its political subdivisions, to serve as sole trustee under a qualified indenture for securities of these issuers, without an order on application under Section 310(a)(1). An eligible trust company must be subject to supervision or examination pursuant to the Trust Companies Act (Canada), R.S.C. 1985, or the Canada Deposit Insurance Corporation Act, R.S.C. 1985. Rule 10a-5 also requires each Canadian trustee relying upon the rule to file on Form F-X an appointment of a person in the United States as agent for service of process.[61]

A Canadian trustee applying solely for permission to act as the institutional indenture trustee must use Form T-6 and complete Item 1, General Information; Item 15, Substantial Equivalency of Trust Regulation in the Foreign Jurisdiction and Eligibility of United States Trustees to Act as Sole Trustees in the Foreign Jurisdiction; and Item 16, List of Exhibits. [Where Form T-6 is also used to ensure that the trustee meets the TIA's eligibility requirements, additional items similar to those called for in Form T-1 must be completed.]

How Do Fiscal and Paying Agency Agreements Differ from Indentures?

Regulated entities such as banks and insurance companies issuing debt securities in exempt transactions often use a fiscal and paying agency agreement instead of an indenture. Underwriters are generally comfortable with a fiscal and paying agency agreement for these issuers and transactions.

The main difference between a fiscal and paying agency agreement and an indenture is that the fiscal and paying agent does not have a fiduciary duty to the holders of the debt securities. Holders of the debt securities must act on their own if there is an event of default (*i.e.*, they must accelerate their own note. The fiscal and paying agent will not accelerate a debt security upon the request of a holder). Holders of debt securities issued under a fiscal and paying agency agreement do not have a way to communicate with each other. Fiscal and paying agency agreements are not governed by the TIA, so the TIA's provisions requiring holders' lists to be available are not applicable.

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59 Multijurisdictional Disclosure and Modifications of the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902 (June 21, 1991), C.C.H. Fed. Sec. L. Rep. 84,812; Multijurisdictional Disclosure: Eligibility of British Columbia Trustees and Exemption for British Columbia Trust Indentures from Specific Provisions of the Trust Indenture Act, Commission Rel. No. 33-7002 (June 10, 1993), C.C.H. Fed. Sec. L. Rep. ¶ 85,203.

60 Effective December 31, 2012, Form F-9 was removed by the Commission. Securities Act Release 33-9245 (July 27, 2011). Rule 10a-5, however, has not been updated.

61 Rule 10a-5(d).

Generally, a note issued under an indenture is a short document, taking most of its provisions from the indenture and only summarizing certain provisions. A note issued under a fiscal and paying agency agreement includes all material provisions, spelling out events of default and voting provisions in detail.

Checklist of Key Questions

- ✓ Are the indenture and the Form T-1 exhibits to the registration statement when it becomes effective?
- ✓ Does the prospectus include the disclosures required by the TIA?
- ✓ Are any potential trustee conflicts of interest disclosed in the prospectus?
- ✓ Is the debt security or transaction exempt from the requirements of the TIA?

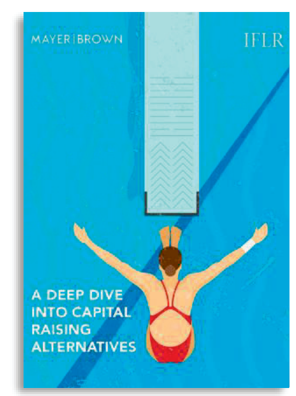
ADDITIONAL RESOURCES

Free Writings & Perspectives

Our blog, Free Writings & Perspectives, provides up-to-the-minute news regarding securities law developments, particularly related to capital formation, as well as commentary regarding developments affecting private placements, late stage private placements, PIPEs, IPOs and the IPO market and new financial products.

http://www.freewritings.law.

A Deep Dive Into Capital Raising Alternatives

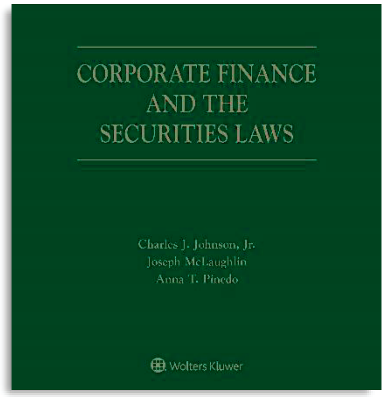


Published by the International Financial Law Review, A Deep Dive into Capital Raising Alternatives provides an overview of the Jumpstart Our Business Startups (JOBS) Act, including the IPO on-ramp provisions, Regulation A, Regulation Crowdfunding, the changes to the Securities Exchange Act of 1934 threshold for U.S. Securities and Exchange Commission (SEC) reporting, and the changes eliminating the prohibition against general solicitation in connection with certain exempt offerings.

The book provides context on the changes in market structure and market dynamics that led to the enactment of the JOBS Act. Specifically, the trend for many private companies to remain private longer, defer or dispense with traditional IPOs in the United States, and rely on private capital to fund their growth. The book also offers some insights into alternative approaches to becoming a public company, including direct listings and merging into SPACs.

http://bit.ly/3d2sSVA.

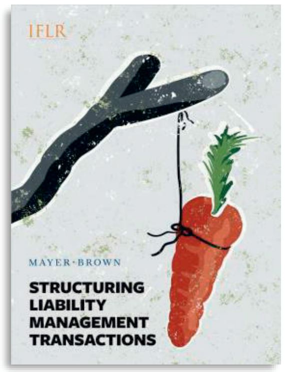
Corporate Finance and the Securities Laws



Corporate Finance and the Securities Laws is the "go to" resource which explains the mechanics of corporate finance together with the statutes that govern each type of deal. The Seventh Edition covers a wide range of financing techniques – from IPOs to private placements and other exempt offerings, shelf-registered offerings, offshore offerings, stock buybacks, tender and exchange offers, debt restructurings, spin offs, convertible securities, asset backed securities and insurance linked securities. It also addresses liability issues and due diligence, anti-manipulation rules and the capital markets related FINRA rules.

https://bit.ly/3NnH62d.

Structuring Liability Management Transactions



The *International Financial Law Review*'s Structuring Liability Management Transactions provides a summary of the U.S. legal framework, including guidance provided in numerous no-action letters issued over many years, applicable to debt repurchases, tender offers and exchange offers.

The Mayer Brown authors also present some of the main regulatory and tax considerations that should be taken into account when determining the best approach.

https://bit.ly/3me9qre.

Writing on the Wall

Writing on the Wall offers explanations and definitions for over 1,000 securities, capital markets, derivatives, structured finance and financial services terms and phrases.

Access the glossary at www.writingonthewall.com.

WHAT'S THE DEAL?