U.S. Regulation of the International Securities and Derivatives Markets, § 2.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.01 (11th and 12th Editions 2014-2017)
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p. 2-3

This chapter provides a general overview of the principal issues a foreign company should consider when deciding whether to offer securities in the United States for the first time, and, if it wishes to do so, whether to offer them in the U.S. public or private markets. The issues are presented in summary form, with references to the detailed discussions appearing elsewhere in this treatise. When we refer to foreign companies and the requirements applicable to them, we are referring to "foreign private issuers"—companies organized outside the United States with either 50% or fewer U.S. shareholders or lacking other specified U.S. connections.

With respect to accessing the U.S. public markets, the focus in this chapter is on those issues that can affect the feasibility of, or substantially delay, a public offering, that impose substantial burdens on the company in connection with or following a public offering or that might be considered particularly sensitive by the company's senior officers, directors or major shareholders. Foreign companies already public outside the United States may also seek to have their shares trade in the U.S. public market without conducting a U.S. public offering, for example by listing outstanding shares on a U.S. exchange or arranging for them to be traded over the counter. Listing on a U.S. exchange subjects the issuer to many of the same burdens as a public offering, but is unlikely to be as effective in developing a deep and stable U.S. shareholder base. Arranging for over the counter trading is, on the other hand, very simple, but is even less likely to have a major impact. It could, however, be a low-cost way of engaging with the U.S. market for the first time, to help guide decisions about next steps. We discuss those alternatives in Chapter 3 as part of a more detailed discussion of the principal advantages and disadvantages of accessing the U.S. markets.

U.S. Regulation of the International Securities and Derivatives Markets, § 2.02, GENERAL CONSIDERATIONS

U.S. Regulation of the International Securities and Derivatives Markets
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[1] Public Offerings

Conducting a public offering and listing in the United States, likely as part of an international offering, can afford a number of benefits. Most important, because of expected U.S. demand, the pricing might be enhanced and the size of the offering increased, adding to liquidity. The United States remains the deepest capital market in the world, and in a U.S. public offering securities may be offered not just to large institutions but to all U.S. investors. A public offering thus maximizes U.S. demand. Moreover, in some sectors, for example high tech, valuations could be better in the United States than elsewhere.

In addition, securities sold in a U.S. public offering generally may be freely resold in the United States thereafter, providing U.S. investors easy access to an

p. 2-4

active secondary market. This access reduces the risk of a liquidity discount that might apply in a U.S. private placement; as discussed in § 7.01, privately placed securities are not freely tradeable in the United States for a year, and if there is no liquid trading market outside the United States, this restriction could have a significant impact.

Once a foreign company is public in the United States, it can take advantage of streamlined procedures for subsequent offerings, so-called shelf registration, and if it is of a certain size, will have instant access to the U.S. markets as a well-known seasoned issuer. It will also find it easier to use its securities as currency for the acquisition of U.S. companies (or other companies with a large U.S. shareholder base). Shelf registration is discussed in § 3.02[2], and the use of securities in acquisitions in § 9.05[4].

The regulatory process for a U.S. public offering, which we discuss in Chapter 3, is relatively straightforward compared to the processes in other leading international listing venues, such as London and Hong Kong. Substantive review is carried out by one regulator (the SEC), and the reports and opinions required of auditors, legal advisors and other experts are limited; in the case of auditors, for example, the "comfort letter" is the only item provided beyond their audit opinion. The processes in London and Hong Kong by contrast involve more extensive third-party reports and opinions, in particular from accountants, and these can be costly and time consuming to prepare. The need for certain of these additional reports and opinions is driven principally by the relevant listing rules and/or the requirements of the investment bank acting as one of the lead underwriters that is chosen by the company to act as its "sponsor." The sponsor has certain responsibilities with respect to the integrity of the listing processes in London and Hong Kong. Moreover, in Hong Kong, two regulatory authorities— the Securities and Futures Commission and The Stock Exchange of Hong Kong Limited—provide substantive review, which can complicate and delay the process. In addition, Hong Kong only permits listings by companies incorporated in certain eligible jurisdictions.

With respect to corporate governance, the United States generally imposes relatively few requirements on foreign companies, deferring instead to the company's jurisdiction of incorporation or foreign listing authority for these matters, except insofar as audit committees and internal controls are concerned. This contrasts with the requirements in Hong Kong and standard practice in London, where in each case the composition of a company's board of directors and board committees is more tightly regulated as a consequence of obtaining a listing.

Balanced against these advantages of accessing the U.S. public market are a number of challenges, including:

- coordinating a U.S. public offering with a concurrent listing and public offering in the issuer's home or other foreign market;

p. 2-4
p. 2-5

- strict auditing and financial statement requirements, and the willingness of the SEC accounting staff to challenge a company's application of accounting principles;
- potentially burdensome audit committee and internal control requirements;
- extensive disclosure requirements, both in connection with the offering itself and pursuant to subsequent ongoing reporting obligations;
- potential liability for inaccurate or incomplete disclosure in a threatening litigation environment, which permits class actions on the basis of liability standards that are considerably easier for plaintiffs to establish than the intentional or reckless misconduct that is required to be proved under customary anti-fraud provisions; and
- active enforcement by the SEC and the criminal division of the U.S. Department of Justice ("DOJ"), including in respect of violations of U.S. law that take place predominantly outside the United States, such as under the anti-bribery provisions of the Foreign Corrupt Practices Act (the "FCPA").

Compounding these challenges, the ongoing requirements applicable to a foreign company that has gone public in the United States can change dramatically from the requirements in place when the offering was conducted, as they did in 2002 with the adoption of the Sarbanes-Oxley Act. That act added substantial new requirements regarding audit committees and internal controls, as well as clawback of executive compensation in the event of certain accounting irregularities. And the United States is perhaps more likely than other countries to adopt changes not merely to meet traditional investor protection concerns but also to serve wider social objectives. This appears to have been the case, for example, in the recently adopted requirement for U.S. public companies to disclose their use of conflict minerals sourced from the Democratic Republic of the Congo or adjoining countries. Finally, although a foreign company that does go public in the United States can eliminate the applicable ongoing requirements through delisting and deregistration, it may do this only if the United States represents a de minimis proportion of its trading and shareholder base and certain other conditions are met.

[2] Private Offerings

A foreign company can avoid many of these challenges by accessing the U.S. private market instead. The most common way of accessing this market is by offering the securities to large U.S. institutions—qualified institutional buyers, or "QIBs"—on the basis of Rule 144A under the Securities Act, generally in conjunction with a listing and public offering elsewhere. Though not as deep as the U.S. public market, the Rule 144A market is substantial, and can generate

p. 2-5
p. 2-6

significant pricing benefits, especially if the QIBs are able to resell the securities they buy into a relatively liquid foreign market after the offering. For a company offering debt securities, or whose local or other foreign equity market is liquid, a Rule 144A offering is generally the preferred option.

None of the initial or subsequent ongoing requirements and other concerns referred to above would apply in a Rule 144A offering, and liability to private plaintiffs would be only for fraud (though the SEC could still bring an enforcement action against the foreign company and its underwriters for negligence). For reasons of marketing, reputation and liability protection, however, the scope of disclosure and due diligence in a Rule 144A offering tends to approach that of a U.S. public offering, though there is considerable flexibility where obstacles appear.

As a practical matter the scope of disclosure in the U.S. offering document is determined by what foreign rules require, what the company wants to disclose, what the underwriters ask the company to disclose for marketing purposes (which itself is often driven by the scope of disclosure of public companies in the same sector) and what the U.S. lawyers require in order to deliver so-called 10b-5 letters. These are letters, required by the underwriters to be delivered at closing in both U.S public offerings and private placements, in which the U.S. lawyers state in effect that, having reviewed the affairs of the company, nothing has come to their attention to make them believe that the prospectus (or other offering document) contains a material misstatement or omission.

In rare cases, a foreign company may be unable to access either the public or private markets in the United States. While, generally speaking, a company reluctant to enter the U.S. public market for one reason or another should be able to offer securities in the less regulated U.S. private market, there may nonetheless be critical disclosures it is unable or unwilling to make, at least at the time of the offering, and the failure to do so would preclude issuance of a 10b-5 letter. Common instances involve disclosure in respect of significant recent or probable acquisitions, contingencies arising from potentially illegal conduct and sensitive matters relating to major shareholders, such as related party transactions and beneficial ownership. In addition, a foreign "investment company" is not permitted to offer its securities to the public in the United States, and may offer its securities on a private basis in ways that are relatively straightforward for debt but more difficult for equity. The definition of "investment company" is broad, capturing not only mutual funds and other collective investment vehicles but also industrial or other companies that hold minority interests in businesses that account for at least 40% of their value and do not benefit from an applicable exception. This "inadvertent investment company" issue is discussed in § 15.02. Careful attention should be paid to a foreign company's possible status as an investment company early in the process if there is cause for doubt.

U.S. Regulation of the International Securities and Derivatives Markets, § 2.03, CONSIDERATIONS WITH RESPECT TO A U.S. PUBLIC OFFERING

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Before considering the specific issues that might be of concern to a foreign company deciding whether to access the U.S. public market, the ways in which the conduct of a U.S. public offering can affect the foreign component of an international offering should be understood. There are three principal areas: timing, publicity, and disclosure.

In the absence of special considerations, and assuming the availability of the requisite financial statements and other financial information, it could take two to three months for a private company to prepare a registration statement (which includes the prospectus) for filing with the SEC and for offering participants to complete their due diligence. To allow a foreign company to coordinate its initial public offerings in and outside the United States, the SEC permits a foreign company with or concurrently seeking a listing outside the United States to engage in the SEC review process confidentially until comments have been resolved. This accommodation also applies to foreign governments registering debt securities, foreign issuers being privatized by foreign governments and foreign issuers that can demonstrate that the public filing would conflict with the law of an applicable foreign jurisdiction. We discuss the possibility of confidential review in § 3.02[1][c].

The SEC staff will generally take about one month to review and comment initially. The time required to respond to and resolve SEC comments will vary, depending on the nature of the comments themselves. It is generally only after the SEC's comments are resolved that the prospectus is printed and the marketing is begun in the United States. It is generally undesirable for marketing to commence in one market before it commences in others, so a foreign company could find that any concurrent local or other foreign market listing and public offering it intends to conduct could be delayed pending completion of the U.S. review process.

The United States has rules designed to ensure that only the publicly filed and SEC-reviewed prospectus is used to market the offering in the United States, rather than other marketing materials. Accordingly, publicity in the United States is strictly limited. Section 3.02 covers what a company can say and when during the offering process. While these rules are not intended to interfere with publicity elsewhere, the steps required to isolate the United States from publicity abroad in the age of the internet can be difficult and burdensome. We discuss these steps in § 3.02[3]. Violations of the rules can lead the SEC to delay the offering or to require the company to include the offending communications—for example, projections or other forward-looking statements—in the prospectus, exposing offering participants to heightened risk of liability.

Finally, with limited exceptions, the United States does not defer to the requirements of foreign markets when it comes to disclosure—it follows the national treatment model. A foreign company seeking to access the U.S. public market must, therefore, generally follow the same rules that apply to U.S. companies and comply with the U.S. disclosure requirements, which may be more extensive than those applicable in its home market. While the SEC has made some accommodations for foreign companies by exempting them from or modifying certain disclosure requirements, the rules are broadly similar. And because it is generally undesirable to offer securities in different markets on the basis of materially different information, as a practical matter the more extensive U.S. disclosure requirements can determine substantial aspects of the disclosure in the local or other foreign markets where a foreign company may be listing and conducting a public offering. On the other hand, some disclosure requirements in other markets—such as with respect to the inclusion of projections in the prospectus—are inconsistent with U.S. practice, and as a consequence raise difficulties.

[1] Auditing and Financial Statement Requirements in a U.S. Public Offering

A company's financial statements constitute a critical part of its prospectus. In the case of a U.S. public offering, the United States regulates the relationship between a company and its auditors, how the audits are to be conducted, the accounting principles that may be used, the periods to be covered and, in the case of recent or probable acquisitions, the inclusion of target financial statements and pro forma financial information. Collectively, these requirements can have a substantial impact on the feasibility and timing of a U.S. public offering.

[a] Auditor Independence

A foreign company conducting a U.S. public offering must include financial statements in its prospectus that have been audited by accountants that are "independent" within the meaning of U.S. rules. These rules, discussed in § 5.03[1], not only prohibit the provision of certain services that accounting firms often provide while they are acting as a foreign company's auditors but also regulate certain other aspects of the relationship between a company and its auditors. Auditor independence is a threshold issue that must be considered at an early stage to avoid unwelcome surprises down the road.

[b] Conduct of Audits

p. 2-8

p. 2-9

In addition to imposing strict requirements on auditor independence, the United States also requires auditors to be registered with the Public Company Accounting Oversight Board ("PCAOB") and to conduct their audits in accordance with PCAOB generally accepted auditing standards. These requirements are described in § 5.03[3]. If a company has not been audited in accordance with these U.S. standards, additional auditing work may be required.

[c] Accounting Principles

Generally, a foreign company has the option to prepare its financial statements in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), International Financial Reporting Standards issued by the International Accounting Standards Board ("IASB-IFRS") or any other comprehensive body of accounting principles. A company that has adopted accounting principles other than U.S. GAAP or IASB-IFRS, including other variants of International Financial Reporting Standards, must provide in its financial statements a "reconciliation" to U.S. GAAP that quantifies the material variations between the company's results under its chosen body of accounting principles and U.S. GAAP. These rules are described in § 4.05[2]. Regardless of the accounting principles a company has adopted, the SEC is perhaps more likely than any other regulator to ask questions about a company's financial statements, making it desirable to resolve any potential significant accounting issues at an early stage, usually through a pre-filing conference with the SEC's accounting staff.

[d] Periods Covered and Segment Breakdowns

Section 4.05 sets out in detail the financial statement requirements in SEC registration statements and other filings. In the initial public offering of any foreign company whose financial statements are under U.S. GAAP, two years of audited financial statements are required; otherwise, generally three years are required. In addition, unaudited interim financial statements must be included if the offering takes place more than a specified period after the date of the most recent audited balance sheet. As a practical matter, any unaudited interim financial statements will have to be "reviewed" by the company's auditors. The financial statements must also contain a note showing a breakdown of key balance sheet and income statement line items by business and geographic segment for each period covered.

[e] Target Financial Statements and *Pro Forma* Financial Information

p. 2-9
p. 2-10

If a company has recently acquired another business that is significant as defined by the SEC, or if a significant acquisition is probable, financial statements of the target and pro forma financial information showing the impact of the acquisition may be required. The applicability of this requirement, and the periods the financial statements of the target must cover, vary depending on the size of the target relative to the acquirer. If financial statements are required, they must be audited and prepared in accordance with the same rules that apply to the issuer's financial statements. Difficulties can arise if the requisite target financial statements are not readily available, and waivers are difficult to obtain. The requirements regarding the inclusion of target financial statements and pro forma financial information are set forth in § 4.05[5][a].

[2] Audit Committee and Internal Control Requirements in and Following a U.S. Public Offering

As noted above, the United States generally defers to a foreign company's jurisdiction of incorporation or foreign listing authority for corporate governance matters. A significant exception to this rule relates to audit committee and internal control requirements, most of which were introduced by the Sarbanes-Oxley Act after the accounting scandals relating to Enron, WorldCom and other companies. Other internal control requirements were introduced earlier, in the mid-1970s, by the FCPA in the wake of the bribery scandals of that time. In addition, U.S. rules specifically prohibit certain conduct by company personnel in the company's dealings with its auditors, and the SEC has brought a number of proceedings against individuals alleging violations of these rules, which we discuss in § 5.03[5].

[a] Audit Committee Requirements

Any foreign company listing its securities on a U.S. stock exchange must have an audit committee whose independence may be phased in over time. Initially, the committee must have at least one independent director, after 90 days a majority must be independent, and after a year all must be independent. The independence requirements include prohibitions on the receipt of consulting, advisory or other compensatory fees and limits on stock ownership. At least one member of the committee is expected to be a "financial expert," and if that is not the case, the company must explain why not.

The audit committee must have power over the appointment, compensation and oversight of the company's auditors (who must report directly to the

p. 2-10
p. 2-11

committee), must have the authority to engage independent counsel and other advisors and must establish procedures for the receipt, retention and treatment of complaints regarding accounting controls or auditing matters and allow employees to make confidential and anonymous submissions of concerns regarding those matters.

We discuss these audit committee requirements in § 5.02.

[b] Controls

The control requirements that apply to any publicly held company in the United States (a "U.S. public company") can be burdensome to meet. In particular, the cost of meeting the requirements relating to "internal control over financial reporting" has been an important factor in decisions by a number of foreign companies against going public in the United States.

[i] *Internal Control Over Financial Reporting and Auditor Attestation*

The management of each U.S. public company, with the participation of its CEO and CFO, is required to evaluate the effectiveness, as of the end of each financial year, of the company's internal control over financial reporting. "Internal control over financial reporting" is a term of art defined as a process designed 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 and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

Each U.S. public company must include in its second annual report filed with the SEC and in all annual reports thereafter an internal control report containing:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control over financial reporting; and

p. 2-11

p. 2-12

- an assessment by management of the effectiveness of this internal control as of the end of the most recent financial year, including a statement as to whether or not internal control over financial reporting is effective.

The auditors of any U.S. public company meeting a certain relatively low size test (generally, a market capitalization of more than $75 million held by non-affiliates) are required to provide an "attestation report" of management's evaluation of internal control over financial reporting. This attestation report must also be included in the company's annual report.

Any company that is an "emerging growth company" when it goes public in the United States may defer the auditor attestation (but not the management report) on internal controls until the earlier of the time when it ceases to meet the definition of an "emerging growth company" and five years after the IPO. An "emerging growth company" is one that at the time of its initial public offering in the United States has less than $1 billion in annual gross revenues, has not issued more than $1 billion in non-convertible debt securities over the past three years and does not have a market capitalization of more than $700 million held by non-affiliates.

We discuss internal control over financial reporting and auditor attestations in § 5.04[2].

[ii] *Disclosure Controls and Procedures*

As we discuss in § 5.04[3], U.S. public companies are also required to maintain "disclosure controls and procedures," another term of art. Disclosure controls and procedures cover both financial and non-financial information, and are defined as controls and other procedures designed to ensure that information required to be disclosed is recorded, processed, summarized and reported in a timely and accurate manner. Management of a U.S. public company is required to evaluate, with the participation of its CEO and CFO, the effectiveness of its disclosure controls and procedures as of the end of each financial year.

The SEC has recommended that companies establish disclosure committees, comprising a small number of key management employees with responsibility for disclosure and reporting matters (such as the CFO, the head of treasury, the director of investor relations, the director of communications, the chief accounting officer, the chief compliance officer and the general counsel) that meets regularly to coordinate disclosure policy and practice.

[iii] *Books and Records Requirements of the FCPA*

Any foreign company conducting a U.S. public offering becomes a U.S. public company and therefore subject to the FCPA. The FCPA is far broader than

p. 2-12

p. 2-13

its name implies and includes "books and records" provisions that apply not only to bribery-related violations but also to a company's accounting controls generally.

As we discuss in § 5.04[5], the FCPA requires U.S. public companies to maintain books, records and accounts that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company and to devise and maintain an adequate system of internal accounting controls. Such system must be sufficient to provide assurances that:

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria and maintain accountability for assets;
- access to assets is permitted only in accordance with management's authorization; and
- actual corporate assets are compared with recorded assets at "reasonable intervals" and "appropriate action" is taken if there are discrepancies.

The criminal division of the DOJ and the SEC staff have stated that those provisions "form the backbone for most accounting fraud and issuer disclosure cases brought by the DOJ and SEC."

[iv] *CEO/CFO Certifications*

The CEO and CFO of a U.S. public company must provide specified certifications as part of each annual report relating to its accuracy and completeness, the fairness of the presentation in the company's financial statements of its financial condition, results of operations and cash flows and the adequacy of the company's internal control over financial reporting and disclosure controls and procedures.

In addition, the annual report must be accompanied by a separate written statement of the CEO and CFO certifying that the report fully complies with applicable disclosure requirements and that the information contained in the report fairly presents the financial condition and results of operations of the company.

A CEO or CFO providing a false certification could be subject, in his or her personal capacity, to SEC actions and private actions and, in certain cases of knowing or willful misconduct, criminal liability.

We discuss these certification requirements in § 5.04[4].

[v] *Reporting Illegality; Special Investigations*

p. 2-13

p. 2-14

The United States requires a public company's auditors to report violations of law of which they become aware to appropriate governing bodies within the company and, where the illegality is material to the financial statements and the company fails to take remedial action, to appropriate governmental authorities. The company's lawyers are also required to report violations of law to appropriate officers or governing bodies within the company. In addition, whistleblowers are given material monetary and other incentives to act, and are protected against retaliation. The rules regarding auditors, lawyers and whistleblowers are described in §§ 5.03[1], 5.05[4] and 5.05[5], respectively.

If a board of directors of a U.S. public company becomes aware, through its auditors, lawyers or otherwise, of possibly material illegal conduct, the best practice is for it to commission a special investigation, supervised by a committee of independent directors and conducted by experienced outside counsel. These investigations can be intrusive, burdensome and costly, and may lead to difficult public disclosure, but in the end they can help mitigate the consequences to the company if illegal conduct did occur and the SEC or DOJ seeks to enforce the law. The anti-bribery provisions of the FCPA have recently given foreign companies that have gone public in the United States cause for concerns of this kind. These matters are discussed in § 5.04[5].

[3] Disclosure Requirements in and Following a U.S. Public Offering

The United States has an integrated disclosure system, described in detail in Chapter 4, meaning that the requirements that apply in the initial public offering form the basis for the annual report that is required each year thereafter. In each case, the company is required to include audited financial statements, describe its business in considerable detail, analyze its financial condition, results of operations (including on a segment basis), liquidity and capital resources and set out the risks to which it is subject. These requirements do not differ substantially from those that apply elsewhere, for example, in London or Hong Kong, though in some sensitive areas of disclosure, for example in relation to related party transactions, greater detail may be called for. With respect to interim reporting, the U.S. securities laws generally allow a foreign company to furnish whatever it publishes elsewhere, though the U.S. stock exchanges require at least half-yearly interim reporting, on an unaudited basis.

[a] Special Industry Disclosure

The United States has specific disclosure requirements for companies in certain industries, such as banking, oil and gas and mining, which we discuss in

p. 2-14

p. 2-15

§§ 4.07[8], 4.07[5] and 4.07[4], respectively. The information called for can, in some cases, go well beyond what is required in other markets.

For example, banks are required to disclose average balance sheet data, including interest-earning assets and interest-bearing liabilities, as well as corresponding average rate and yield data. Generally, daily averaging is required, though if collecting this data would involve unwarranted or undue burden or expense, end-of-week or end-of-month averaging may be allowed instead.

Since 2008, the United States has permitted oil and gas companies to disclose probable and possible reserves in addition to proven reserves, and has largely adopted international definitions. However, the reserves, production, drilling and other information required to be disclosed by oil and gas companies still is more extensive than what is required in other markets. On the other hand, the United States continues to prohibit the disclosure of oil and gas resources other than reserves, except when required by foreign law.

The SEC is currently in the process of revising its mining disclosure requirements to align them more closely with international reporting standards. In addition, U.S. public companies are required to disclose, in an exhibit to their annual reports, certain information relating to violations of the U.S. Federal Mine Safety and Health Act of 1977 and mining-related fatalities.

[b] Related Party Transactions

Transactions and proposed transactions between the company and related parties, discussed in § 4.07[10], are required to be disclosed if those transactions occurred within the past three financial years and involved loans, were material to either the company or the related party or were unusual in their nature or conditions. The list of persons considered to be related parties for these purposes includes:

- entities that are under common control with, control or are controlled by the company;
- unconsolidated entities over which the company has significant influence;
- directors and key management personnel, and certain of their close family members, and enterprises over which any of the foregoing persons have significant influence; and
- shareholders with significant influence over the issuer and certain of their close family members, and enterprises over which any of the foregoing persons have significant influence.

"Significant influence" is defined as "the power to participate in the financial and operating policy decisions of the enterprise but is less than control over those policies. Shareholders beneficially owning a 10% interest in the voting power of the company are presumed to have a significant influence on the company."

Companies are required to disclose the amount of outstanding loans to or from a related party as of the most recent practicable date, the largest amount outstanding during the relevant three-year period, the nature of the loan and transaction in which it was incurred and the interest rate. For other types of transactions with related parties, the nature and extent of the arrangement must be disclosed. As a practical matter, the starting point for related party transaction disclosure is the relevant note to the financial statements, but more detail is often required.

As discussed in § 5.05[1], companies are also prohibited from making or maintaining loans to their officers or directors—one effect of this prohibition is that any outstanding loans to officers or directors must be repaid or otherwise terminated before a U.S. public offering.

[c] Compensation of Officers and Directors; Share Ownership of Officers, Directors and Significant Shareholders

A foreign company conducting a U.S. public offering is required to disclose, in the aggregate, the amount of compensation paid, including contingent or deferred compensation accrued and benefits in-kind granted, to its officers and directors. Compensation paid on an individual basis only needs to be included if required by the company's home country or if that information is otherwise publicly disclosed by the company. If compensation is paid pursuant to a bonus plan or profit sharing plan, or in the form of options, additional disclosure is required. In addition, companies are required to disclose the total amount set aside or accrued to provide pension, retirement or similar benefits. We discuss the requirements for compensation disclosure in § 4.07[9].

A foreign company must also disclose the share ownership of each of its directors and senior officers, as well as any share options held by them. With respect to options, the company must disclose the number of shares covered, the purchase price, if any, the exercise price and the expiration date. If, however, any individual director or senior officer owns less than 1% of the relevant class of shares and that share ownership has not previously been disclosed to shareholders or otherwise made public, the company may state that the individual owns less than 1% of the class instead of providing the individual share ownership. We discuss the disclosure requirements with respect to the share ownership of directors and senior officers in § 4.07[9].

The company must also disclose certain information regarding any holder of 5% or more of any class of its voting securities (or such lesser percentage it is required to disclose in its home country), to the extent the information is

p. 2-16

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p. 2-17

known to the company or can be ascertained from public filings. In addition, to the extent known to the company, it must identify any controlling person and describe the nature of its control, including the amount and proportion of capital held giving a right to vote. Any arrangements known to the company that could result in a change of control must also be disclosed. These requirements are described in § 6.03[2].

[d] Public Filing of Material Contracts

As we discuss in § 4.04[4], a foreign company is required to file publicly with the SEC copies of material contracts at the time of a public offering and in connection with its annual reports. In addition, a summary of each material contract must be included in the offering prospectus or annual report.

Generally, material contracts are those that are not of a type that ordinarily accompanies the kind of business the issuer and its subsidiaries conduct, were entered into within the last two years or remain to be performed in whole or part and are either for an amount material to the issuer or are significant enough for other reasons to be considered material to the issuer. Contracts on which the business is substantially dependent and material leases over property are also considered to be material.

Contracts with directors, officers and significant shareholders are deemed to be material (with one limited exception for the sale of current assets at market price). This includes service contracts for directors and officers.

The public filing of otherwise confidential material contracts may be harmful to a company or violate the terms of the contracts themselves. The SEC has a procedure, discussed in § 3.02[1][c], for requesting the confidential treatment of certain information in public filings, including material contracts. The company must identify the specific portion of any filing that it deems confidential and state the basis for the company's objection to public disclosure of that information, along with an analysis of the applicable exemptions from the rules and regulations under the U.S. Freedom of Information Act. The SEC staff reviews each confidential treatment request and will only grant confidential treatment if the request is narrowly drawn and meets specific criteria, usually relating to the prospect that public disclosure will result in competitive harm. While it is rare for an entire contract to be granted confidential treatment, requests for particularly sensitive provisions to be kept confidential are often granted. This is a matter that should be dealt with early in the public offering process.

[e] Disclosure Requirements to Achieve Social or Political Goals

In recent years, the United States has promulgated laws requiring periodic disclosure by public companies in the United States in order to achieve

p. 2-17

p. 2-18

public-policy goals unrelated to traditional concepts of investor protection. The two principal examples are the conflict minerals disclosure rule, adopted pursuant to § 1502 of the Dodd-Frank Act, and the IRANNOTICE disclosure rule, adopted pursuant to the Iran Threat Reduction and Syria Human Rights Act of 2012. A third example, the resource extraction payments disclosure rule, adopted pursuant to § 1504 of the Dodd-Frank Act, was recently disallowed after its adoption. We discuss the requirements regarding conflicts minerals disclosure below and in § 4.08[1], the IRANNOTICE disclosure requirements below and in § 4.07[13] and the now vacated resource extraction payments disclosure rule in § 4.08[2].

The conflict minerals disclosure is intended to identify the possible direct or indirect financing or benefitting of armed groups in the Democratic Republic of the Congo or an adjoining country (the "covered countries"). It seeks to do this by requiring any U.S. public company to disclose its use of certain minerals originating there. The minerals in question are cassiterite, columbite-tantalite, gold, wolframite and three derivatives: tin, tantalum and tungsten. The requirements apply not just to any of these minerals the company acquires itself but also to those included in any components (including generic components) in the company's products.

In determining what disclosures should be made, the company must first determine whether it manufactures any products for which conflict minerals are necessary to the functionality or production. If not, no filing is required. If so, the company must conduct a "reasonable country of origin inquiry" to determine whether such conflict minerals originated in the covered counties or came from scrap or recycled sources.

If the company determines the conflict minerals did not originate in a covered country or came from scrap or recycled sources, or if it has no reason to believe the conflict minerals may have originated in a covered country or reasonably believes the conflict minerals came from scrap or recycled sources, the company must make such disclosures but need not file a conflict minerals report.

If the company determines that any of the conflict minerals originated in a covered country and are not from scrap or recycled sources or has reason to believe that such minerals may have originated in a covered country or does not reasonably believe that such minerals are from scrap or recycled sources, it must conduct due diligence on the source and chain of custody of the conflict minerals. Due diligence efforts must conform to a nationally or internationally recognized due diligence framework. The company must then prepare and disclose a conflict minerals report that describes the due diligence process undertaken, any product that contains conflict minerals that the company cannot determine are not directly or indirectly financing or benefitting armed groups in a covered country, the facilities used to process the conflict minerals used in those products,

p. 2-18

p. 2-19

the country of origin of those minerals and the company's efforts to determine the mine or location of origin with the greatest possible specificity.

In 2012, Congress passed the Iran Threat Reduction and Syria Human Rights Act, which among other things requires any company that is required to file quarterly or annual reports to make specific disclosures in its public filings if it or an affiliate has knowingly engaged in certain activities or transactions with Iran or other specified countries or entities. Disclosure, which is made annually on a form designated as the IRANNOTICE, must include: (i) the nature and extent of the activity; (ii) the gross revenues and net profits attributable to the activity; and (iii) whether the issuer or affiliate intends to continue the activity. As a result, while it is not *per se* illegal for non-U.S. companies listed in the United States to engage in business with U.S.-sanctioned parties linked to Iran, failure to make the required disclosures constitutes a violation of U.S. securities law and may result in civil and criminal penalties.

[4] Potential Liabilities in and Following a U.S. Public Offering

As we discuss in Chapter 11, the risk of litigation can be a significant deterrent to entering the U.S. public market: private litigation in connection with the offering itself or in relation to communications thereafter is facilitated by an active plaintiffs' bar and the possibility of class actions; and public authorities, such as the SEC and the criminal division of the DOJ, play an active role in enforcing the securities laws.

The standard of liability that applies in a U.S. public offering is unusually stringent. The issuer faces strict liability for material misstatements or omissions in the prospectus used in the offering—it has no defense. Directors, the CEO, CFO and chief accounting officer, and the underwriters, are also liable, unless they can show they conducted adequate due diligence. Even controlling shareholders can be held liable in certain circumstances. We discuss potential liability in a U.S. public offering in § 11.03.

On the other hand, the standard that applies to communications after the offering, including in reports filed with the SEC and in press releases, is akin to fraud and generally requires knowing or reckless misconduct. Though these fraud standards may be formally less stringent than those in foreign markets, where a negligence standard is not uncommon, the active plaintiffs' bar and prevalence of class actions can make the United States a more threatening litigation environment even with respect to post-offering communications, notwithstanding the formal difference in the standard of liability. We discuss potential liability for post-offering communications and class actions in §§ 11.05 and 11.09[a].

The SEC and the criminal division of the DOJ also actively enforce the U.S. securities laws, both in connection with public offerings and in relation to

p. 2-19

p. 2-20

ongoing reporting and other communications to the market thereafter. The enforcement powers of the SEC and DOJ are described in §§ 11.07, 11.08 and 11.09. The SEC also has the power to bar any person from being an officer or director of a U.S. public company if the person has violated the U.S. securities laws in ways that demonstrate unfitness to serve as an officer or director. This power is described in § 11.07[2][b].

In addition to pursuing companies for disclosure and accounting controls violations, the SEC and the criminal division of the DOJ have recently stepped up their enforcement of the anti-bribery provisions of the FCPA, giving rise to substantial settlements by, and reputational damage to, foreign companies that have gone public in the United States. *See* § 11.08.

Finally, under the Sarbanes-Oxley Act, in the event of a restatement of a U.S. public company's financial statements by reason of material non-compliance as a result of misconduct, the CEO and the CFO must reimburse the company for all incentive or equity based compensation paid in the years for which the financial statements are restated, and pay the company all profits from the sale of any of the company's securities during the 12-month period following publication of the incorrect financial statements. This is described in §§ 5.05[2] and 11.07[2][a]. More recently, the SEC, pursuant to the Dodd-Frank Act, proposed a rule that would require U.S. stock exchanges to impose an even stricter "clawback" obligation on current and former executive officers of a listed company, which has not yet been adopted. *See* § 5.05[2].

[5] Communications with Research Analysts in and Following a U.S. Public Offering

Going public in the United States can affect how a foreign company deals with research analysts in several ways, which we discuss in § 4.10.

First, in connection with the U.S. public offering itself, research reports may not be distributed into the United States, though they may be distributed elsewhere as part of the international marketing effort. This requires the underwriters to implement procedures to ensure that their analysts do not send their research reports into the United States.

Second, once public in the United States, a foreign company should not provide material non-public information to analysts unless it makes that information available to the general public at the same time. While the specific regulation applicable to U.S. companies prohibiting selective disclosure to analysts does not apply to foreign companies, any failure to comply with the principles that lie behind it could subject a foreign company, and any of its directors or officers involved in the communication, to liability for insider trading under the anti-fraud provisions of the U.S. securities laws.

p. 2-20

p. 2-21

Third, it is important that research reports published after a foreign company is public in the United States be the work of the analysts and not of the company, to minimize the risk that any such entanglement might subject the company to anti-fraud liability for alleged misstatements or omissions in those reports. Accordingly, U.S. public companies limit their involvement with research reports to reviewing them for factual accuracy.

Finally, communications with analysts or to the public through press releases or otherwise can impose on a company a duty to update them should circumstances change. Although courts have generally held that routine earnings guidance will not give rise to that duty because such guidance is inherently uncertain, companies have been found to have breached a duty to update where they fail to update a forward-looking statement when it expressed as a matter of company policy (*e.g.*, a leverage policy or other predicates to a financial projection) after that policy has changed.

[6] Reporting and Sales by Significant Shareholders Following a U.S. Public Offering

Going public in the United States affects not only the company but also its significant shareholders. As noted above, controlling shareholders can be liable for material misstatements or omissions by the company in certain circumstances. In addition, significant shareholders must report their ownership publicly. And, perhaps surprisingly, shareholders who are considered to be "affiliates" of the company face limitations on how they may sell their shares in the United States, notwithstanding a prior U.S. listing of those shares.

[a] Reporting

Any person who beneficially owns or acquires at least 5% of the voting rights in a U.S. public company is required to report that ownership publicly in a filing with the SEC. Once the 5% threshold is crossed, increases or decreases in beneficial ownership are required to be reported as well. The requirements are discussed in § 6.04.

[b] Sales

Generally, once a foreign company goes public in the United States, its shares may be freely sold there by the shareholders. As mentioned above, and as discussed in § 6.06, restrictions do apply, however, to sales by shareholders considered to be "affiliates" of the company. An "affiliate" of a company is any person that controls, is controlled by or is under common control with the company,

p. 2-21

p. 2-22

and can include, for example, shareholders holding more than 10% of the voting rights in the company as well as directors and executive officers.

An affiliate of a company that goes public in the United States may subsequently sell shares only in the following ways:

- Pursuant to a further registration statement filed by the company with the SEC covering the shares to be sold, often through a "shelf registration";
- Subject to certain volume and manner-of-sale restrictions;
- In a private placement, including under Rule 144A if the shares were issued prior to the company's U.S. listing; and
- Outside the United States.

In addition, affiliates of the company are generally subject to "lock-up" agreements with the company's underwriters, preventing sales for a certain period after an offering.

Because of the prohibition in the United States on trading on the basis of material non-public information, officers and directors restrict their trading in the company's securities to certain "window" periods that follow financial reporting by the company and then only if the company, which generally monitors requested trading by officers and directors, is comfortable there is no material non-public information at the time. *See* § 5.05[7].

[7] Delisting and Deregistration

Any U.S. public company may delist its securities from a U.S. exchange by furnishing the exchange with a copy of the Board resolutions authorizing delisting.

A foreign company that has offered its shares to the public in the United States may terminate its ongoing obligations only if:

- It has had, for at least 12 months, a listing on an exchange in a foreign jurisdiction, which, either singly or together with one other foreign jurisdiction, accounted for at least 55% of the trading worldwide (and, if aggregating two markets, at least one had more trading than the United States);
- It meets one of the two following tests:
    - the average daily trading volume in the United States was no greater than 5% of the average on a worldwide basis during a recent 12-month period; or

p. 2-22

  - the shares are held by fewer than 300 holders on a worldwide basis or less than 300 holders in the United States;
- It has met all its reporting obligations for 12 months and has filed at least one annual report with the SEC; and
- It has not conducted a U.S. public offering for 12 months, subject to certain limited exceptions.

If a foreign company cannot meet these tests, it will remain subject to U.S. ongoing requirements, including any that were implemented after it went public in the United States. We discuss the delisting and deregistration rules and processes in § 4.11.

U.S. Regulation of the International Securities and Derivatives Markets, § 2.04, CONSIDERATIONS WITH RESPECT TO A U.S. PRIVATE OFFERING

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

As we discuss in Chapter 7, if a foreign company finds that the benefits of a U.S. public offering are outweighed by the challenges, a Rule 144A offering is an attractive alternative. QIBs comprise a substantial part of the U.S. capital market, and the demand they represent can enhance the pricing and increase the size of an international offering, particularly where there is a liquid foreign market where resales can be made after the offering, reducing or eliminating any liquidity discount. We discuss the resale of privately placed securities into markets outside the United States in § 8.02[2].

None of the requirements in and following a U.S. public offering apply in and following a Rule 144A offering, and there is no review by a U.S. regulator. It is therefore relatively straightforward to integrate a Rule 144A offering with a listing and public offering in a foreign company's home or other foreign market. Generally speaking, the foreign requirements will be the starting point for determining the timing of the offering and the scope of disclosure.

Nonetheless, the anti-fraud provisions of the U.S. securities laws do apply to a Rule 144A offering, and recklessness, as well as intent, can satisfy the scienter requirement. Moreover, the SEC may bring actions for negligent disclosure as well. We discuss the potential for liability in a private offering in §§ 7.02[4] and 11.04. Accordingly, although, as a technical matter, the restrictions on publicity and the distribution of research reports in the United States are more relaxed in a Rule 144A offering, liability concerns have led offering participants to isolate the United States from these communications in the same way as in a U.S. public offering. We discuss publicity and research in connection with private offerings in §§ 7.02[4] and 7.02[5].

U.S. marketing considerations and the potential for liability under the U.S. securities laws tend to drive disclosure in the offering document and related due

p. 2-24

diligence by the underwriters (including receipt of 10b-5 letters) towards the norms of a U.S. public offering. Although international and U.S. practices with respect to the scope of due diligence have converged over time, there may still be some aspects of U.S. practice, such as review by the U.S. lawyers of several years' worth of minutes of a company's board of directors and key board committees, that may be viewed as unduly intrusive. We describe U.S. due diligence practices in §§ 11.03[1] and 11.03[2].

Where disclosure or governance difficulties arise in a Rule 144A offering, however, there is considerably more room for flexibility than in a public offering. For example:

- If a foreign company's auditors are independent under a widely recognized foreign standard, that should suffice, even if there would be questions under the U.S. definition, and audits conducted under widely recognized auditing standards should be sufficient as well;
- Reconciliation of a foreign company's financial statements to U.S. GAAP should not be required even if the financial statements are prepared under accounting principles other than IASB-IFRS, so long as they are widely recognized;
- If, in the event of a recent or probable acquisition, financial information for the target company is not available in the form required for a U.S. public offering, alternatives can be considered, depending on the size of the target relative to the acquiror;

- The company need not meet the audit committee and control requirements of a U.S. public company, though acceptable control systems will be necessary, and some members of the board and its key committees should be independent; and
- While the special disclosure requirements that apply to banks, oil and gas companies and mining companies may not be disregarded, they can be applied flexibly, recognizing, for example, in the case of banks, that averaging on a quarterly or even semi-annual basis may be acceptable, and in the case of oil and gas companies, that resources other than reserves may be disclosed and all the detail called for by the U.S. rules need not be provided.

We discuss these and similar issues in § 7.03.

As a practical matter, the company's underwriters, and the U.S. lawyers for the company and the underwriters, will provide guidance as to what should be included in the offering document to meet U.S. marketing needs and reduce U.S. legal risk. U.S. investors will be comparing the company to similar businesses

p. 2-24

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p. 2-25

that may well be public in the United States, and will wish to be provided information that is similar in scope, driving disclosure towards U.S. public offering standards. And for purposes of legal protection, the underwriters will require U.S. counsel to deliver 10b-5 letters in relation to the offering document, and the starting point for U.S. counsel here will be the scope of disclosure in a U.S. public offering.