

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.01, 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 § 10.01 (11th and 12th Editions 2014-2017)

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Chapter 10 describes the practical issues encountered in certain common or challenging types of cross-border securities offerings, particularly those involving non-U.S. issuers. The key underlying legal concerns are discussed in other chapters: Chapter 3 for the regulatory regime applicable to a foreign private issuer making a registered offering (the U.S. public market), and Chapters 7 and 8 for the rules applicable to offerings exempt from registration (the private and offshore markets). <sup>11</sup>

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### **Footnotes**

- 1 Securities with features of a derivative present special issues that are addressed in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.02, CONTINUOUS OFFERINGS**

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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 § 10.02 (11th and 12th Editions 2014-2017)

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Continuous offering programs provide flexibility for issuers to offer various types of securities in various forms of transactions. These programs allow issuers to take advantage of market opportunities as they arise by tailoring the terms of the securities offered to the needs of the issuer or the demands of potential purchasers identified by the dealers. The following forms of continuous offering programs are discussed in this section: at-the-market equity offerings; and debt issuance programs, including medium-term note ("MTN") programs, Euro Commercial Paper ("ECP") programs and warrants. With respect to continuous offerings of securities to investors in the United States, an issuer may register such a program on a shelf registration statement to the extent it is eligible to register securities for primary issuance on Form S-3 or F-3 (the procedures and process of which are discussed in [Chapter 2](#)), or conduct such offerings in reliance on an exemption from the registration requirements of the Securities Act (such as so-called "Reg S/144A programs" or "Reg S only" programs).

### **[1] At-the-Market Equity Offerings**

#### **[a] Overview**

Equity "dribble-out" programs, also known as equity distribution "programs" or "arrangements," <sup>[2]</sup> involve sales by an issuer, from time to time on a continuing basis, of equity securities at market prices through an agent (typically an investment bank acting in that capacity). Offers and sales made pursuant to these programs must comply with the provisions of Rule 415(a)(4) under the Securities Act, which governs at-the-market offerings and limits them to companies eligible to use Form S-3 or Form F-3 to offer securities on their own

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behalf. <sup>[3]</sup> Other regulatory concerns will generally limit participation in equity distribution programs to issuers with a public market float of \$150 million or more. <sup>[4]</sup>

For eligible issuers, equity distribution programs offer certain advantages over traditional fixed-price underwritten equity offerings. Most importantly, equity distribution programs offer significant flexibility by giving an issuer the right to ask the agent to make sales under the program from time to time without obligating the issuer to sell at any other time. This allows the issuer to control the amount and timing of each drawdown, and also enables it to set a minimum sales price. In addition, using an equity distribution program may help an issuer minimize disruptions to its share price by curtailing the market impact of sales under the program, since large blocks of stock need not be sold at any one time and the issuer need not offer a discount to the stock's market price in connection with those sales. <sup>[5]</sup> Accordingly, by making sales pursuant to an equity distribution program, the issuer can opportunistically take advantage of stock price movements (so long as it does not possess material non-public information). Such offerings also may be attractive because of the potentially lower risk of perceived failure if the issuer is unable to sell all of the securities it has registered (thereby avoiding the detrimental market impact of announcing a transaction that then falls short).

The at-the-market offering structure is not new, but was developed long after the Securities Act was first adopted. Indeed, prior to the adoption of Rule 415 under the Securities Act in 1982, continuous offerings of equity securities on a primary basis were not permitted. <sup>[6]</sup> As a result of subsequent amendments to rules under the Securities Act over time, however, such offerings are now relatively commonplace. <sup>[7]</sup>

Historically, certain categories of issuers, particularly those with predictable but significant capital requirements, have used at-the-market offerings more frequently than other issuers. <sup>[1]</sup> These programs frequently involved sales of only small volumes of equity at any one time, which generally made them less attractive to larger, well-capitalized issuers. <sup>[2]</sup> More recently, however, equity distribution programs—while still used frequently by issuers with ongoing capital needs, such as utility, mining and energy companies—have also become attractive to other U.S. and non-U.S. issuers, particularly in times of significant volatility in the global equities trading markets. Programs have ranged in size up to as large as \$1.5 billion with the time required to complete sales under each program varying widely and, in some cases, measured in days rather than weeks or months.

## **[b] Documentation and Process**

The documentation used in an at-the-market offering of equity securities, which is discussed in more detail below, is in many respects similar to that used in a standard fixed-price underwritten offering. The primary documents include a shelf registration statement, a related prospectus and a sales agency/distribution agreement, <sup>[3]</sup> as well as various supporting documents from accountants, lawyers and other parties. The offering process, however, varies from the

paradigm of a standard underwritten offering in certain respects due to the continuing nature of the offering process, which requires (among other things) the issuer to keep its registration statement and prospectus up to date and the agent to continually update its "due diligence" procedures with respect to the issuer.

*Corporate Authorization.* The issuer must have in place all necessary corporate authorizations to permit sales to be made under the program on an episodic basis. In the United States, corporate governance and other state law requirements relating to equity issuance may, however, in some cases create additional complexities. Under the laws of some jurisdictions, for example, the issuer's board of directors (or a committee thereof) might be required to authorize each separate equity issuance. <sup>[4]</sup> While it should generally be possible to address these concerns (for example in the instance above, by establishing a pricing committee whose members can act independently to approve sales on any particular day and an appropriate process by which that approval can be given as needed), it is important to bear in mind that such complexities may arise. In jurisdictions outside the United States, it will be necessary to address local law considerations, such as the existence of preemptive rights.

*Shelf Registration Statement.* In order for an issuer to proceed with an at-the-market equity offering, the offering must come within Rule 415(a)(1)(x) under the Securities Act, <sup>[5]</sup> meaning that the issuer must have registered the equity securities in question on a shelf registration statement on Form F-3 or Form S-3. Frequently, particularly in the case of companies with larger market capitalizations, the issuer will already have a shelf registration statement on file.

If that is not the case, however, or if the issuer's existing shelf does not contemplate the issuance of common stock, the issuer must file a shelf registration statement in connection with the at-the-market offering. <sup>[6]</sup> If the issuer intends to use an existing shelf registration statement, the plan of distribution included in the prospectus that is part of the registration statement need not specify that it can be used for at-the-market offerings as, pursuant to Rule 430B, the issuer can amend that plan of distribution simply using a prospectus supplement and without the need to file a post-effective amendment to the registration statement. <sup>[7]</sup>

*Prospectus.* The shelf registration statement described above will include a prospectus setting out the terms of the securities and the means by which they can be offered. In many cases, this will be a base prospectus that sets forth such information in only general terms. If so, the base prospectus will need to be accompanied by a prospectus supplement providing additional detail about the at-the-market offering. <sup>[8]</sup> If an issuer files a

registration statement solely in connection with the at-the-market offering, however, the prospectus may "stand alone" without the need for a prospectus supplement.

In either case, the prospectus will need to contain detailed information about the at-the-market offering, including in particular the maximum number of shares to be sold, and the identities of the designated sales agent or agents under the equity distribution program. <sup>[16]</sup> The issuer will be able to amend the plan of distribution in the prospectus at any time while sales under the program are ongoing by means of a prospectus supplement (meaning, for example, the issuer can add or remove agents, or provide for the sale of securities registered for sale under the program *via* a firm commitment underwriting, without filing a

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post-effective amendment to the registration statement). <sup>[17]</sup> The prospectus will also incorporate by reference the issuer's Exchange Act filings and must be kept up to date to ensure it is current each time the issuer sells shares under the program. Both Form F-3 and Form S-3 permit filings to be incorporated by reference to Exchange Act filings, including on Form 6-K <sup>[18]</sup> (for foreign private issuers) and Form 8-K (for U.S. issuers).

When making purchases under an equity distribution program, investors should have the same information they would have in any other offering registered under the Securities Act. Rule 159 under the Securities Act makes clear that § 12(a)(2) of the Securities Act requires an assessment of the information that has been conveyed to investors at the time of sale in determining any potential liability thereunder, and specifies that information conveyed after that time should not be taken into account. Insofar as sales under an equity distribution program take place over a securities exchange or alternative trading system, neither the issuer nor the sales agent will have any direct communication with investors. Accordingly, such information must be provided by means of public dissemination into the market from time to time, including filings on Forms 6-K and 8-K. The amount of time prudentially required between the initial dissemination of any such information and subsequent sales under the program will depend on various factors, including the materiality of any particular development and the liquidity of the market for the issuer's securities.

*Sales Agency/Distribution Agreement.* In connection with commencement of an equity distribution program, the issuer will enter into a sales agency/distribution agreement with one or more broker-dealers who will act as agents for the shares being sold under the program. <sup>[19]</sup> Under the terms of that agreement, on each trading day (or as otherwise specified in the agreement) the issuer will identify to an agent the number of shares that it would like the agent to sell on its behalf on that day. The issuer may also choose to specify a minimum sales price or otherwise limit the agent's discretion to make sales. The agent will then attempt to sell those shares to purchasers generally on a best efforts, agency basis. <sup>[20]</sup> The issuer will pay the agent a commission with respect to the shares it

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sells (generally up to 2–3% of the purchase price). In addition, the agreement will generally provide that the agent can act as a principal on a firm commitment basis for sales, subject to agreeing to the terms of that sale in a separate terms agreement (and the issuer filing a prospectus supplement describing that change to the Plan of Distribution).

Many of the other provisions of a sales agency/distribution agreement are generally similar to those in a standard underwriting agreement. <sup>[21]</sup> This is in part because, as noted above, the agent will be considered an "underwriter" for purposes of the Securities Act and will want to obtain the same protections that an underwriter would typically receive. These provisions, including the delivery of accountants' comfort letters and opinions of counsel (including Rule 10b-5 negative assurance letters), will assist the agent in establishing a due diligence defense under the Securities Act. Certain provisions of the sales agency/distribution agreement will, however, differ from those in a traditional underwriting agreement. The most significant difference relates to the sales agent's need to update its due diligence on an ongoing basis so long as sales continue under the program.

The terms of the sales agency/distribution agreement will typically require issuers to provide bring-down

accountants comfort letters and opinions of counsel (including Rule 10b-5 negative assurance letters) on a quarterly basis in connection with the filings of the issuer's Form 10-Qs and Form 10-K (or, for foreign private issuers, the filings of the issuer's Form 20-F and possibly any Form 6-Ks that contain interim financial statements), although at least some programs require that agent's counsel provide these only at launch, and not on an ongoing basis. The issuer also will be deemed to repeat its representations and warranties in connection with each takedown, and be required to provide bring-down officers' certificates and to make management available for due diligence discussions on at least a quarterly basis. In practice, issuers are generally asked to provide bring-down officers' certificates more frequently, and, depending on the level of program activity, to make available one or more members of senior management for bring-down due diligence calls on a weekly or bi-weekly basis. These additional steps will typically be agreed between the agent and the issuer when they are setting up the program, but they may not be set forth in detail in the sales agency/distribution agreement. The agreement generally will also provide that the agent has the right to require the issuer to produce comfort letters, opinions, certificates and such other information as it may need for due diligence purposes upon reasonable request. Such a request might, for example, be made in connection with material developments involving the company, its

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operations or the industry in which it operates, a large sale under the program, or a resumption of sales under the program following a temporary hiatus.

Sales agency/distribution agreements also generally do not include lock-up provisions that would bind the company, directors or officers, given the continuing nature and potentially lengthy duration of the offering. Instead, the company will typically be required to notify the agent some period of time, usually three to five business days, before engaging in transactions in respect of its equity securities,<sup>[22]</sup> and the agreement will not impose any restrictions on directors or officers.<sup>[23]</sup> Accordingly, issuers will be able to engage in ordinary-course activity while a program is ongoing, but the notification provision will protect the agent from being surprised by unanticipated issuances or purchases.

A third difference between traditional underwriting agreements (at least with U.S. domestic issuers) and equity sales agency/distribution agreements relates to the payment of expenses. Issuers have, in many instances, agreed to pay at least a portion of the agent's expenses, including legal fees (both in connection with launching the program and, to the extent required, for ongoing work relating to it), particularly if the agreement is terminated by the issuer before all or some portion of the securities registered under the program are sold; such reimbursements are, however, frequently subject to a cap or range.

*Public Announcements.* Issuers typically announce the launch of an equity distribution program *via* press release, largely we believe because they view it as important to advise the market of their ability to raise additional capital through the program. In addition, issuers will often want to provide the market a short but easily understood explanation of the program concurrently with the filing of the program prospectus with the SEC. These press releases typically are drafted to comply with Rule 134 under the Securities Act, so they will not constitute free writing prospectuses.<sup>[24]</sup> During the life of the program, the issuer will typically

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rely on the information included in, in the case of foreign private issuers, its Form 20-F and possibly Form 6-K filings (or, in the case of U.S. issuers, its Form 10-K, Form 10-Q and any Form 8-K filings), together with any prospectus supplements filed to update the prospectus, to advise investors of the status of the program.<sup>[25]</sup>

*Marketing.* Equity distribution programs generally will not involve any special marketing efforts resembling those used in a traditional underwritten offering. There are three principal reasons for this. First, both agents and issuers will want to avoid engaging in special marketing efforts as part of minimizing the possibility that the offering would be considered a distribution for purposes of Regulation M under the Exchange Act.<sup>[26]</sup> Second, as sales under the program often take place in transactions between broker-dealers on an exchange or through an alternative trading facility, the utility of any such marketing efforts is likely minimal. Finally, as discussed in more

detail below, publicity in connection with a registered offering is generally subject to significant restrictions, and it would be potentially burdensome for an issuer to constantly review any proposed marketing materials in addition to otherwise monitoring communications to ensure compliance with the securities laws.

*Sales Orders.* Once the program has commenced, the issuer will advise the agent from time to time when it would like the agent to sell securities on the issuer's behalf. These sales orders are typically given orally (subject to prompt confirmation via e-mail). The issuer will dictate the timing, frequency and, to a limited extent, the terms of sales under the program. <sup>[27]</sup> Certain limitations may also be imposed by the relevant board authorization (e.g., a mandated minimum sales price). Issuers can change the terms of future sales at any time, or revoke a previously given authorization to sell (at least to the extent such sales have not yet taken place).

*Settlement.* After the close of trading on each day equity securities are sold, the agent will generally be required to advise the issuer how many shares have

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been sold, the gross and net proceeds to the issuer relating to such sales, and the compensation payable to the agent in connection therewith. <sup>[28]</sup> Settlement will typically occur on a T+3 basis, with shares delivered on the settlement date against payment therefor by the agent. Although similar in many respects to settlement in a traditional underwritten offering, the mechanics for an equity distribution program vary in certain respects. For example, since sales are being made on a continuing basis, the company's transfer agent likely will not receive on each settlement date the documents it might typically receive in a traditional underwritten offering, such as an opinion of counsel as to the validity of the securities being issued. In order to ensure that everything will flow smoothly at settlement, the transfer agent should be brought into the equity program process as early as possible.

## **[c] Issues of Particular Interest to Issuers and Agents**

Continuing at-the-market equity offerings present a number of legal and practical concerns for both issuers and agents. Most of these arise simply because the issuer is selling securities on a continuing basis, which requires the disclosure in its prospectus to be constantly monitored and updated as necessary. Questions also arise, however, as to whether sales under a program will constitute a "distribution" of securities for purposes of Regulation M under the Exchange Act (and, if so, the extent to which that might impose limitations on the activities of both agents and issuers). Some of the principal issues of note are discussed in detail below.

*Due Diligence and Updating.* Both the issuer and the agent will need to ensure that the prospectus at the time of sale is current. If at any time the issuer possesses material non-public information, it must either suspend use of the program or update the prospectus and the marketplace by filing information with the SEC to keep the program prospectus current. <sup>[29]</sup> Updates may also be required for the shelf registration statement to comply with the disclosure requirements of Form F-3 or S-3 (e.g., if the financial statements included or incorporated by reference in the registration statement are not current). <sup>[30]</sup> Accordingly, the issuer will

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need to consider carefully on any day it decides to sell securities whether its existing public disclosure is complete and accurate in all material respects. <sup>[31]</sup> In some cases, this may require the issuer to accelerate filings of its Form 6-Ks or Form 8-Ks—although the requirements of the form itself may permit an issuer several days to make a particular filing, the program prospectus will nonetheless be deficient if the information is material and the filing has not yet been made.

*Disclosure of Proceeds.* Issuers participating in equity distribution programs have generally taken steps to update the market regarding the number of shares they have sold and the proceeds generated from those sales on a periodic basis, generally by providing updated information in each annual or quarterly periodic report filing made after commencement of a program until either all the securities registered for sale have been sold or the program has been terminated. So long as there is no change in what the proceeds will be used for from what is

described in the prospectus supplement for the program—typically, for general corporate purposes—no further prospectus supplement regarding proceeds need be filed.

*Prospectus Delivery.* Insofar as sales under an equity distribution program are made in compliance with Rule 153 under the Securities Act, <sup>[32]</sup> neither the issuer nor the agent will be required to deliver a physical or electronic prospectus to investors in connection with those sales for purposes of § 5(b)(2) of the Securities Act. Rule 153 provides that a prospectus is deemed to have been delivered for those purposes with respect to any transaction taking place on a national securities exchange (or facility thereof), a trading facility of a national securities association or on an alternative trading system, so long as (i) securities of the same class as those that are the subject of the transaction in question are trading on that exchange, facility or system, (ii) a registration statement relating to the offering is effective and (iii) the issuer has filed or will file a prospectus satisfying the requirements of § 10(a) of the Securities Act with the SEC.

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*Regulation M and Other Distribution-Related Concerns.* Regulation M strictly prohibits stabilization activities during an at-the-market offering. <sup>[33]</sup> Accordingly, neither the issuer nor the agent may engage in any stabilizing activities with respect to the shares being sold pursuant to a sales agency/distribution agreement. Regulation M similarly prohibits passive market-making on Nasdaq during an at-the-market offering. <sup>[34]</sup>

The agent and issuer may in some cases also face additional restrictions on their respective activities when sales are taking place under an equity distribution program. The question to be considered is whether a "distribution" of the equity securities in question is taking place for purposes of Regulation M. In considering shelf registration generally, the SEC has indicated participants must individually examine each shelf takedown to determine whether it is a distribution (i.e., whether it satisfies the "magnitude of the offering" and "special selling efforts and selling methods" criteria of a distribution). The SEC has indicated that ordinary trading transactions into an independent market, which do not involve special selling efforts, generally will not be considered a "distribution." <sup>[35]</sup> If, however, an agent enters into an agreement with an issuer that provides for "unusual transaction-based" compensation, that may suggest a distribution is occurring even if the sales are being made in ordinary trading transactions. <sup>[36]</sup> Accordingly, while parties to any particular equity distribution program might reasonably conclude that sales thereunder do not constitute a distribution, in other cases (particularly programs involving a large volume of stock or commissions higher than those for ordinary secondary market transactions)

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distribution could be deemed to be taking place. A cautious agent might accordingly choose to treat any reasonably active ongoing equity distribution program as a distribution for purposes of Regulation M, even if that approach were overly restrictive, simply to avoid a case-by-case analysis of the question.

If a distribution is deemed to be taking place, as noted above, that will affect certain activities of the agent and issuer. Rules 101 and 102 of Regulation M generally prohibit any participant in a distribution from bidding for, purchasing or attempting to induce any person to purchase a "covered security" during the restricted period applicable to the offering. In most cases for issuers participating in an equity distribution program that restricted period will likely be only one business day prior to pricing. However, given the nature of the at-the-market program—which provides for sales potentially every day—if an agent is required to comply with Rule 101, it would be essentially precluded from trading the securities in question so long as the program was ongoing, unless the issuer were to agree to provide the agents advance notice of an offering equal to the applicable restricted period. <sup>[37]</sup>

Most equity distribution programs are structured to avoid this potential concern by requiring the issuer to represent its equity securities fall within the exception for actively-traded securities set forth in Rule 101(c)(1) of Regulation M (this exemption applies to distribution participants such as underwriters, but not to issuers). That exemption requires the securities to have an average daily trading value ("ADTV")—essentially, the worldwide ADTV over a recent 60-day period—of at least \$1 million and the issuer to have a "public float value"—

essentially, the value of the company's equity securities held by non-affiliates—of at least \$150 million. <sup>[38]</sup> The sales agency/distribution agreement

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will also typically contain a mutual covenant providing that if either party believes the issuer is no longer eligible for the exemption, it will promptly notify the other party and suspend sales under the program. Because the ADTV exemption will generally be available, the activities of the agent should not be unduly constrained by Regulation M while program sales are ongoing, whether or not such sales would be deemed a distribution.

Issuers, however, will face more significant restraints on their activities. Rule 102 of Regulation M, which applies to the issuer in a distribution, is generally more restrictive than Rule 101, and would limit in certain respects the ability of an issuer to engage in transactions involving the securities that were the subject of the equity distribution program. An issuer would not, however, be precluded from market activities relating to certain other equity securities. For example, nothing in Regulation M would prohibit an issuer from repurchasing convertible debt securities while sales of the underlying common stock were taking place pursuant to an equity distribution program, as those convertible debt securities would be neither a "covered security" nor a "reference security" for purposes of Regulation M. Similarly, an issuer may be able to engage in other, separate distributions of its equity securities at the same time it is making sales under the program, although confirming this may require consideration of the relevant facts and circumstances. <sup>[39]</sup>

*Research Publication.* If an agent (or any of its affiliates) distributes research about an issuer while the issuer's equity distribution program is ongoing, it must abide by the Securities Act restrictions governing distribution of research by underwriters during a registered securities offering. As a practical matter, in the case of an equity distribution program, the agent and its affiliates will generally be permitted to continue publishing equity research pursuant to the exemption provided by Rule 139(a) under the Securities Act, as that safe harbor

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largely depends on whether the issuer is a seasoned Exchange Act reporting company ( *i.e.*, eligible to use Form S-3 or Form F-3 in a primary offering), which must be the case for issuers with equity distribution programs. Whether the other requirements of Rule 139(a) are met will depend on the extent of the agent's prior research-related activities involving the issuer. <sup>[40]</sup> Rule 139(a) research reports need not be limited as to content. <sup>[41]</sup>

In addition, irrespective of the availability of Rule 139, many investment banks internally impose prudential restrictions on the issuance of research about an issuer when involved in an ongoing distribution of that issuer's securities. <sup>[42]</sup>

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*Conflict Clearance and Other Internal Procedures of the Agent.* Any agent participating in an equity distribution program will need to consider how best to address any conflicts of interest that it may have or that may arise while the program is ongoing. Such conflicts could, for example, arise in connection with other securities offerings by the issuer, or if the agent acts as an advisor to the issuer or another party in connection with a merger or other strategic transaction.

*Publicity.* Because any equity distribution program will involve a continuing offering of securities registered for sale with the SEC, the issuer and the agent will need to observe publicity guidelines of the sort that would be appropriate for any other registered offering while the program is ongoing. In particular, they usually will take appropriate steps to ensure they are not conditioning the market, and cannot engage in unusual publicity activities that might be deemed an "offer" of securities under the program, because that could result in related written materials (such as press releases or articles) being deemed a prospectus, trigger a requirement to file a free writing prospectus with the SEC and impose liability on the contents of the free writing prospectus. Reporting issuers of the sort that will be able to use an equity distribution program should, however, be able to take full advantage of the publicity safe harbors available under the Securities Act, particularly the ones provided



by Rule 168 for regularly released factual business information and forward-looking information and by Rule 134 with respect to certain limited information about the offering. <sup>[43]</sup>

*FINRA and Other Regulatory Concerns.* Even though equity distribution programs involve securities registered for sale on Form F-3 or Form S-3 by issuers with a public float of at least \$150 million, if the issuer in question has an Exchange Act reporting history of less than 36 months, the agent and issuer may be required to file the equity distribution program for clearance by FINRA, even if the issuer is a well-known seasoned issuer, unless it is also an issuer of investment-grade long-term debt. <sup>[44]</sup> This will also be the case if the issuer has a public float of less than \$150 million, as FINRA Rule 5110(b)(7)(C) currently requires that issuers must comply with the requirements of Form S-3 or Form F-3

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applicable to primary offerings by registrants as in effect prior to October 21, 1992 in order to be exempt from FINRA filing requirements.

Since offerings under equity distribution programs will generally involve securities that are listed on a U.S. national securities exchange, U.S. state "blue sky" laws relating to state registration and review should be preempted. <sup>[45]</sup>

*Specific Concerns for Foreign Private Issuers.* As noted above, several foreign private issuers have entered into equity distribution programs. From a U.S. securities law perspective, such issuers face concerns generally similar to those faced by domestic U.S. issuers, as the rules applicable to continuous at-the-market offerings are generally the same in both cases. In considering issues relating to Regulation M, an agent may rely on the trading of the foreign private issuer's common equity securities outside the United States in determining whether that issuer meets the ADTV and public float value tests under Rule 101. <sup>[46]</sup>

Foreign private issuers may, however, face additional challenges with respect to some of the other, more procedural aspects of an equity distribution program. For example, in the case of an issuer whose U.S.-traded equity securities consist of American Depositary Shares rather than the underlying equity securities, on each settlement date the issuer will be required to issue shares, deposit those shares with a depository and then cause the depository to credit the agent so that the agent can credit the purchasers. Therefore, a foreign private issuer's ADR depository will need to be involved in establishing and administering an equity distribution program. Furthermore, the corporate approvals required in the issuer's local jurisdiction to permit equity securities to be sold in a series of transactions at varying prices over a potentially lengthy period of time may differ from those typically required under U.S. state law.

## [2] Debt Issuance Programs

Continuous offerings include debt issuance programs, such as medium-term note programs, commercial paper programs and warrant offerings. Registered debt issuance programs may be established under the shelf registration rules, and commercial paper programs may be set up to comply with the exemption from the registration requirements pursuant to § 3(a)(3) of the Securities Act. Unregistered debt issuance programs may be established pursuant to the exemptions provided under Regulation S, with respect to sales of securities issued under the program outside the United States, and Rule 144A, which would allow

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offerings and sales of securities issued under the program to qualified institutional buyers in the United States.

### [a] MTN Programs

A medium-term note or "MTN" program is an uncommitted arrangement between an issuer and one or more dealers for the issuance from time to time of notes with varying terms. Under the program, the dealers purchase notes from the issuer, if and when agreed, or they solicit purchasers of notes as agents for the issuer. Flexibility is crucial because the purpose of an MTN program is to take advantage of market opportunities as they arise by

tailoring the terms of the notes to the needs of the issuer or the demands of potential purchasers identified by the dealers. Accordingly, the terms of the notes may vary as to maturity (typically from nine months or one year to 30 or more years), interest rate basis (fixed or floating), currency (U.S. dollar or foreign) and other matters.

The special feature of an MTN program is not the type of security that may be issued under the program, but its uncommitted nature. Because the purpose of these programs is to take advantage of market opportunities, they establish a framework under which securities can be issued rapidly in accordance with predetermined conditions. The period between an agreement to issue under a program and closing of an issuance is generally two to five business days. In establishing a program, neither the issuer nor any of the dealers commit in advance to a particular issuance or issuances or purchase of any particular securities, but having a framework in place facilitates prompt access to the market. This makes MTN programs, like commercial paper programs for shorter maturities, an attractive approach to raising capital.

For MTN programs, the requirements of Regulation S or Rule 144A apply to each tranche of an MTN program in the same way that they apply to standard underwritten offerings of debt securities, except that the distribution compliance period requirement under Regulation S is applied differently. Section 4(a)(3) of the Securities Act and the requirements of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") also apply to each tranche in the same way that they apply to standard underwritten offerings of debt securities.

In a Category 1 MTN program, where there is no distribution compliance period requirement, U.S. sales restrictions will apply only to unsold allotments (although the dealer exemption in § 4(a)(3) of the Securities Act will not be available for resales in the United States for 40 days after closing). In a program that falls into Category 2 or Category 3 of Regulation S, the distribution compliance period is applied to each "identifiable tranche" separately, and it begins not at the closing date but upon the completion of the distribution of the securities comprising the tranche in question. Because of the uncommitted nature of

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MTN programs, it can be expected that the distribution will in most cases be completed immediately.

For a Rule 144A MTN program, issuers and dealers must comply with the requirements and procedures of Rule 144A as they would apply to a standard underwritten offering, including eligibility of securities for resale pursuant to Rule 144A and information delivery requirements. Securities issued under MTN programs and sold in reliance on Rule 144A are restricted securities under the Securities Act for purposes of resales in the United States, although resales may be made outside the United States in reliance on Regulation S.

## **[b] ECP Programs**

Euro-commercial paper, or "ECP," programs are similar in structure to MTN programs but provide for the issuance of notes with maturities of 365 days or less. The rules for ECP programs are in general the same as for MTN programs, although the TEFRA restrictions generally do not apply. However, notes of U.S. issuers with maturities of greater than 183 days are subject to the certification requirements imposed under the "portfolio interest" rules. Because certification is inconsistent with practice in the ECP market, U.S. issuers generally limit the maturities of their ECP to 183 days or less. U.S. companies that fall within Category 3 of Regulation S and issue ECP without the benefit of a guarantee by a parent falling into Category 1 or 2 of Regulation S generally arrange for their programs to be exempt from the registration requirements of the Securities Act other than under Regulation S, for example under § 3(a)(3) or § 4(a)(2) of the Securities Act, because the applicable safe harbor under Regulation S would require certification. An issuer may also arrange for its ECP programs to comply with § 3(a)(3) or § 4(a)(2) of the Securities Act, or Rule 144A, in order to allow for offers and sales of ECP in the United States without the requirement to register the securities under the Securities Act.

## **[3] Warrants**

Warrant offerings are viewed as continuous offerings of the underlying securities, as well as offerings of the

warrants themselves. As with other securities, warrants and the underlying securities may be offered and sold outside the United States in reliance on Regulation S and inside the United States pursuant to an effective registration statement or an exemption from the registration requirements of the Securities Act, such as in reliance on the exemption provided by § 4(a)(2) of the Securities Act and/or the resale exemption provided by Rule 144A thereunder.

### **[a] Warrant Offerings Under Regulation S**

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Generally, the category of an offering of warrants for securities under Regulation S will be the same as that of the underlying securities, although it would be prudent to treat the warrants themselves as a debt security of the issuer of the warrants if such treatment would result in the offering falling into a more restrictive category, even when the warrants provide for the possibility of physical settlement. The length of the distribution compliance period, if any, and the procedures required to exercise the warrants will depend on the kind of underlying securities to be issued upon exercise of the warrants and the category of the offering.

In the case of warrants (i) for securities of the issuer of the warrants, (ii) for securities of a company that is an affiliate of the issuer of the warrants or (iii) for securities the offer and sale of which are not otherwise exempt from the registration requirements of the Securities Act, the distribution compliance period, if any, for the underlying securities will also apply to the warrants and both will be measured from the completion of the distribution of the warrants. In a Category 2 offering, this will generally be 40 days after the completion of the distribution of the warrants, provided that certain requirements are met. These are (i) that the warrants bear a restrictive legend, (ii) that the person exercising a warrant certify in writing that it is not a U.S. person or exercising the warrant on behalf of a U.S. person (or furnish an opinion of counsel as to the availability of an exemption from the registration requirements of the Securities Act) and (iii) that procedures be implemented to ensure that the warrants are not exercised, or the securities delivered, in the United States. In a Category 1 offering, where there is no distribution compliance period requirement, U.S. sales restrictions will apply only to warrants that are unsold allotments, and certification on exercise will be limited to a representation that the person exercising the warrants is outside the United States.

In the case of warrants that are exercisable for outstanding and freely transferable securities of a company that is not an affiliate of the issuer of the warrants, the underlying securities will not be subject to U.S. sales restrictions upon delivery and no certification on exercise will be required because the "sale" of the underlying securities will be exempt from registration generally under § 4(a)(1) of the Securities Act. In this case, the warrants themselves should be subject to whichever category of Regulation S would apply to debt offerings by the warrant issuer.

Warrants on an index do not fit easily into the framework of Regulation S, but to the extent such warrants are settled only in cash, they should be viewed as debt securities (although they generally are not so viewed for purposes of TEFRA). Moreover, because the issuer will not be obliged to deliver securities upon exercise, an offering of such warrants should not be considered a continuous

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offering of the securities that comprise the index. Accordingly, an offering of warrants on an index should be treated in the same way under Regulation S as an offering of debt securities.

### **[b] Warrant Offerings Under Rule 144A**

Sales of warrants in the United States can be made in reliance on Rule 144A. For purposes of determining whether the warrants are eligible for resale under Rule 144A, in addition to the requirement that the warrants, when issued, may not be of the same class as warrants listed on a national securities exchange in the United States or quoted on a U.S. automated inter-dealer quotation system, the securities underlying physically <sup>[47]</sup>

settled warrants may not, at the time such warrants are issued, be of the same class as securities listed on a national securities exchange in the United States or quoted on a U.S. automated inter-dealer quotation system unless the warrants have at least a three-year term and an effective exercise premium at the time of issuance of at least 10%. <sup>[48]</sup>

Where warrants have been sold to U.S. persons in reliance on Rule 144A, and the underlying securities are unseasoned at the time of exercise, U.S. persons may only exercise physically settled warrants if:

- they certify on exercise they are qualified institutional buyers;
- the underlying securities are eligible for resale under Rule 144A (see above) at each time of exercise; and
- the issuer of the underlying securities is a reporting company under the Exchange Act, or is subject to and complies with the requirements of Rule 12g3-2(b) under the Exchange Act or agrees to satisfy the information furnishing requirement of Rule 144A in another way for so long as the warrants are exercisable.
- The ordinary procedures for conducting a Rule 144A placement also apply in the context of warrants, such as the broker-dealer registration requirements of the Exchange Act.

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#### Footnotes

2 We refer to such programs collectively as "equity distribution programs."

3 This will require companies to have a public float held by non-affiliates of at least \$75 million and have been timely filers under the Exchange Act for at least one year. In 2007, the SEC liberalized the eligibility requirements for Forms S-3 and F-3 for primary offerings to allow companies with a public float of less than \$75 million to use the forms, so long as, among other things, the aggregate market value of securities sold by the issuer in the offering and during the preceding 12 months did not exceed one-third of the company's public float. See SEC Release No. 33-8878 (Dec. 19, 2007); Form S-3; Form F-3.

4 See § 3.02[9] discussing Regulation M and other distribution-related concerns.

5 Although individual takedowns should be minimally disruptive, the establishment of the program itself could create market "overhang" and have a negative effect on the stock price.

6 SEC Release No. 33-6334 (Aug. 6, 1981), 46 Fed. Reg. 42,001, 42,002 (Aug. 18, 1981) (noting that the proposed rule "would permit, for the first time, primary offerings of equity securities on a continuous basis").

7 Rule 415 proposed permitting for the first time at-the-market primary offerings of equity securities (which, at the time, was a novel idea). The SEC implemented Rule 415 on a temporary basis in March 1982, and subsequently adopted it permanently in November 1983. Based on its experience during that period, the SEC imposed several restrictions on at-the-market offerings in order to address its concerns and the concerns of market participants regarding the need to maintain orderly trading markets. SEC Release No. 33-6383 (Mar. 3, 1982); SEC Release No. 33-6499 (Nov. 17, 1983).

In July 2005, as part of its extensive Securities Offering Reform initiative, the SEC further revised Rule 415 to eliminate several of these restrictions. See SEC Release No. 33-8591 (July 19, 2005). These rule changes became effective December 1, 2005. Rule 415(a)(4) currently requires only that, in the case of a registration statement that pertains to an at-the-market offering of equity securities by or on behalf of an issuer, "the offering must come within paragraph (a)(1)(x) of this section," which requires that securities to be offered and sold on a continuous or delayed basis by or behalf of the registrant be registered on Form S-3 or Form F-3 (and, accordingly, that the issuer be qualified to register securities on that form for a primary offering). Rule 415(a)(4) defines an at-the-market offering as "an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price."

8 For example, the SEC identified utility companies as one of the principal early users of at-the-market offerings of equity securities. See SEC Release No. 33-6470 (June 9, 1983), 48 Fed. Reg. 27,768, 27,769–

27,770 (June 17, 1983) (noting that, from March 1982 to May 1983, 3,516 shelf registration statements were filed, of which 115 provided for delayed sales of equity securities (35% of which were made by utility companies), and that 19 of those 115 registration statements specified "at-the-market" offerings as one of the potential distribution methods (including seven for dribble-out programs offered by utility companies).

- 9 Prior to July 2005, Rule 415(a)(4) limited the amount of securities that could be registered for sale in an at-the-market offering to no more than 10% of the aggregate market value of the registrant's outstanding voting stock held by non-affiliates.
- 10 The various investment banks have different names for the agreement between the issuer and the agent. Examples include "sales agency agreements," "equity distribution agreements," "distribution agency agreements" and "distribution agreements." Despite the different names, however, these agreements are generally similar in scope and substance. In this book, we refer to such agreements collectively as "sales agency/distribution agreements."
- 11 Many U.S. companies are incorporated in Delaware. On June 24, 2015, 80 Del. Laws, c. 40, § 6 amended § 152 of the General Corporation Law of the State of Delaware (effective Aug. 1, 2015) to provide additional flexibility for authorization of stock issuances. As the Synopsis to the Senate Bill states:

The amendment to Section 152 clarifies that the board of directors may authorize stock to be issued in one or more transactions in such numbers and at such times as is determined by a person or body other than the board of directors or a committee of the board, provided the resolution of the board of directors or committee of the board authorizing the issuance fixes the maximum number of shares that may be issued, the time frame during which such shares may be issued and establishes a minimum amount of consideration for which such shares may be issued. The minimum amount of consideration cannot be less than the consideration required pursuant to Section 153. The amendment further clarifies that a formula by which the consideration for stock is determined may include reference to or be made dependent upon the operation of extrinsic facts, such as, without limitation, market prices on one or more dates or averages of market prices on one or more dates. Among other things, without limitation, the amendment is intended to make clear that the board of directors may authorize stock to be issued pursuant to "at the market" programs without having to separately authorize each individual stock issuance pursuant to such program.

- 12 Rule 415(a)(4) under the Securities Act.
- 13 If the issuer meets the criteria to be considered a "well-known seasoned issuer," it will be able to file a Form S-3 or Form F-3 that will be automatically effective upon filing. § 3.02[2][c]. If, however, the issuer is not a well-known seasoned issuer, it must file a new shelf registration statement and take the steps necessary to have it declared effective (which may include going through an SEC review process).
- 14 Rule 430B, which covers immediate, delayed, and continuous primary offerings by primary shelf eligible issuers pursuant to Rule 415(a)(1)(x), permits an issuer to amend the prospectus included in a registration statement by means of a post-effective amendment, a prospectus supplement filed pursuant to Rule 424, or via incorporation from the issuer's Exchange Act reports. See SEC Release No. 33-8591 (July 19, 2005).
- 15 Note that the base prospectus need not specifically provide for at-the-market offerings, as the plan of distribution in the base prospectus can be amended using a prospectus supplement.
- 16 Any agent who enters into an agreement with the issuer in connection with an at-the-market offering will be considered an underwriter; accordingly, the agent should be named in the prospectus. SEC Release No. 33-6334 (Aug. 6, 1981), 46 Fed. Reg. 42,001, 42,011 (Aug. 18, 1981) ("The [SEC] believes that any market professional ... who purchases a registered security as principal from the registrant or who sells that

security for the registrant as agent ordinarily would be deemed a statutory underwriter under Section 2(11) of the Securities Act even in the absence of a specific written agreement between the issuer and that market professional.").

- 17 See Rule 430B(d) under the Securities Act.
- 18 For a discussion of information that must be filed on Form 6-K, see [§ 4.02\[3\]\[c\]](#). If a foreign private issuer intends to update a shelf registration statement and prospectus by means of disclosures in a Form 6-K, then it will need to designate that Form 6-K (or the relevant portion thereof) as having been incorporated by reference into the shelf registration statement and prospectus.
- 19 The SEC has eliminated the historical requirement that a registrant conduct an at-the-market offering through an underwriter, but in most cases an issuer will face significant practical difficulties in attempting to sell equity securities directly to investors without acting through a broker.
- 20 Even in situations where the issuer has entered into sales agency/distribution agreements with more than one broker-dealer, those agreements will typically provide that only one agent can be instructed on any particular day, to avoid situations where a prospective purchaser would be able to take advantage of more than one agent selling simultaneously by using a multiple bid strategy to get the lowest possible price (since each agent would be, at least in certain respects, incentivized to sell as many securities as it could at any price above any minimum floor price in order to maximize the portion of the commission it would receive relative to the other agent).
- 21 See [§ 3.02\[5\]](#).
- 22 For possible restrictions on the ability of a company or its directors or officers to purchase equity securities during the pendency of an equity distribution program, see below under "[Regulation M](#) and other related concerns."
- 23 Much like the lock-up in a traditional underwriting agreement, this notification provision will include standard exceptions permitting a company, for example, to issue shares without notice if and when outstanding convertible securities are converted, or in connection with an existing employee stock option plan.
- 24 Even if any such release was deemed a free writing prospectus, however, it generally would not need to be filed so long as it was issued concurrently with or after the filing of the program prospectus with the SEC and did not contain substantive changes from or additions to the prospectus. See Rule 433(d)(3) under the Securities Act.

U.S. issuers will also generally file program launch press releases on Form 8-K to ensure compliance with the requirements of [Regulation FD](#). In addition, since the sales agency/distribution agreement would be considered an "underwriting agreement" for purposes of Item 601(b)(1) of [Regulation S-K](#), it should be filed (together with a legality opinion relating to the securities to be issued) on Form 8-K (or 6-K, as applicable) and incorporated into the registration statement relating to the shares being issued. Since, however, the sales agency/distribution agreement in our view should not be considered a "material definitive agreement" (as by its terms it neither obliges the issuer to sell any securities nor requires the agent to purchase any securities from the issuer), we believe, in the case of U.S. issuers, these items should be filed under Item 9.01 of Form 8-K (Financial Statements and Exhibits).

- 25 At completion, issuers will sometimes issue a press release that serves to update the market as to the total amount of securities sold under the program, which will be relevant to investors insofar as it means the company has completed a capital-raising exercise and should also help allay any investor concern regarding potential overhang relating to the program. In addition, if the offering was particularly successful, or was completed rapidly, the issuer may want to issue an announcement in order to benefit from any positive investor reaction.
- 26 See [§ 3.02\[9\]](#) discussing [Regulation M](#) and other distribution-related concerns.
- 27 For example, an issuer may specify a maximum sales volume or a minimum sales price for any particular day, and may also be able to specify certain other sales terms ( e.g., providing that each sale could not exceed a specified number of securities).

- 28 The issuer may be required to disclose the net proceeds from the offering in its periodic reports filed with the SEC (as discussed in more detail below).
- 29 For a discussion of an issuer's potential liabilities under §§ 11 and 12(a)(2) of the Securities Act, see § 11.03[1] and [2].
- 30 To ensure the ability to continue use of an active program, a foreign private issuer will need to update the shelf registration statement on a timely basis by filing its Form 20-F within three months after the end of the fiscal year (as opposed to the four-month period currently applicable to such issuers) and update its financial statements with interim financial information by filing a Form 6-K incorporating that information into the shelf registration statement and prospectus no later than nine months after its fiscal year-end. See Form 20-F, Item 8.A.5.
- 31 Some equity distribution programs prohibit sales when the issuer's directors and officers are subject to a "black-out" period under the company's insider trading policy. While useful as a prudential matter, the underlying question is actually whether the issuer will be in possession of any material non-public information when sales would be taking place. If not, the issuer and agent should be comfortable in going forward with sales under an equity distribution program, even during a black-out period.
- 32 In order to ensure the ability to rely on this rule, the sales agency/distribution agreement will require that sales by the agent comply with Rule 153. Equity distribution programs generally rely on the exemption from prospectus delivery provided by Rule 153, rather than Rule 172 under the Securities Act, because Rule 153 does not require a notice to purchasers pursuant to Rule 173 in connection with such sales.
- 33 Rule 104(e) of Regulation M under the Exchange Act. Although the definition of an "at-the-market" offering under Regulation M is broader than the definition set forth in Rule 415, any offering that falls within the definition for purposes of Rule 415 will also fall within the definition contained in Regulation M. For a discussion of the restrictions of Regulation M more generally, see § 3.02[9].
- 34 Rule 103(a) of Regulation M under the Exchange Act. Passive market-making typically permits broker-dealers to engage in market-making transactions in covered securities that are Nasdaq securities while engaging in a distribution without violating the provisions of Rule 101, so long as those market-making activities are being made pursuant to the restrictions set forth in Rule 103.
- 35 *A fortiori*, an issuer with a "dormant" at-the-market program (*i.e.*, one that has not been used for some time) generally should not be deemed to be engaged in a distribution during that dormant period by analogy to the treatment of individual shelf takedowns under Regulation M. Cf. SEC Release No. 34-38067 (Dec. 20, 1996).
- 36 SEC Release No. 34-38067 (Dec. 20, 1996), 62 Fed. Reg. 520, 526 (Jan. 3, 1997) ("[W]here a broker-dealer sells shares on behalf of an issuer ... in ordinary trading transactions into an independent market (*i.e.*, without any special selling efforts) the offering will not be considered a distribution and the broker-dealer will not be subject to Rule 101. A broker-dealer likely would be subject to Rule 101, however, if it enters into a sales agency agreement that provides for unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions." (footnote omitted)).
- 37 For a general discussion of the restrictions of Regulation M, see § 3.02[9]. The SEC has described in some detail how at-the-market offerings should be considered for purposes of Regulation M. SEC Release No. 34-38067 (Dec. 20, 1996), 62 Fed. Reg. 520, 527 (Jan. 3, 1997):

In an at-the-market offering, sales prices are established during the course of the offering based upon market conditions at the time of individual sales. Accordingly, the restricted period for such an offering would commence one or five business days before the pricing of each sale and continue until the person's participation in the distribution is completed. In practice, the application of Rule 101 will essentially be the same as in the case of a fixed price offering ... because the activities of distribution participants are restricted during the entire

course of offers and sales, whether the securities are sold at fixed or varying prices.

Rule 105(a) of Regulation M, which prohibits purchasers of securities in a public offering from covering certain short sales with those securities, does not apply to at-the-market offerings (since they are not conducted on a firm commitment basis), meaning that investors will be permitted to cover short sales using securities purchased through the program.

- 38 Rule 101(c)(1) provides that the provisions of Rule 101 of Regulation M will not apply to such securities, so long as the agent or an affiliate of the agent did not issue the securities in question. The terms "ADTV" and "public float value" are both defined in Rule 100 of Regulation M.
- 39 For example, an issuer would potentially be able to participate in an exchange offer involving its equity securities while selling shares under an equity distribution program. See SEC, Division of Market Regulation, Staff Legal Bulletin No. 9 (Oct. 27, 1999; revised Apr. 12, 2002), Fed. Sec. L. Rec. (CCH) ¶60,009:

For example, Company A conducts an offering of A common stock for cash. At the same time, Company A conducts an exchange offer in which it distributes A common stock and purchases Company B's common stock. Assuming the cash offering and exchange offer are distributions of A's common stock, Company A may solicit offers to purchase the common stock in the cash offering at [the] same time it solicits offers to exchange securities in the exchange offer, and vice versa. However, a distribution may rise to the level of an impermissible inducement to purchase when a distribution participant engages in sales efforts that go beyond *bona fide* offers to sell or the solicitation of offers to buy the securities in distribution.

The issuer would of course also be required to comply with any other rules or regulations applicable to such an offering.

- 40 See § 3.02[3][a][iii] for a general discussion of the availability of the Rule 139(a) safe harbor. The SEC eliminated the requirement that Rule 139(a) research be published with "reasonable regularity" in July 2005, but made clear that, in order to take advantage of the Rule 139(a) safe harbor, the broker or dealer in question must have previously distributed or published at least one research report about the issuer or its securities, or have distributed or published at least one such report after discontinuing coverage. SEC Release No. 33-8591 (July 19, 2005). We generally believe that, in most cases, an agent acting for an issuer in connection with an equity distribution program (or one of that agent's affiliates) will have previously published at least one research report about that issuer. If, however, that requirement cannot be met, the agent (or its affiliates) could in the alternative potentially rely on the safe harbors provided by Rule 139(b) (permitting publication of industry research reports containing information about the issuer, subject to certain conditions) or by Rule 138.
- 41 Rule 101 of Regulation M also generally restricts dissemination of research about a company when an underwriter is involved in a "distribution" of the issuer's securities, subject to exceptions certain of which are likely to be applicable to most equity distribution programs. The securities being offered will generally fall within the exception for actively-traded securities set forth in Rule 101(c)(1) of Regulation M, and accordingly, the restrictions of Rule 101 of Regulation M will not apply to the agent or its affiliates. In addition, Rule 101(b)(1) of Regulation M would separately permit the publication and dissemination of research pursuant to Rules 138 and 139 under the Securities Act even if the ADTV exemption were not available.



Other regulations may also affect the ability of agents or their affiliates to publish research while an equity distribution program is active. Financial Industry Regulatory Authority ("FINRA") Rule 2241(b)(1)(ii), for example, requires FINRA members to adopt policies and procedures that, at a minimum, prohibit the member from publishing or distributing research regarding a subject company for which the member acted as manager or co-manager of a "secondary" offering for three calendar days following the date of the offering (subject to certain exceptions for reports relating to significant news or events). This prohibition will not apply, however, to publication of a research report in compliance with Rule 139 (or to public appearances by a research analyst) relating to an issuer with "actively-traded securities" as defined in Regulation M. See FINRA Rules, Rule 2241(b)(1)(ii). Accordingly, for the reasons discussed above, this restriction generally will not apply to companies using an equity distribution program as a practical matter (assuming the other conditions of Rule 139 are satisfied).

- 42 We understand that, in some cases, agents have chosen not to apply such restrictions, principally based on the diminished incentives for sales personnel in connection with an equity distribution program, and the potentially long period during which the restrictions would apply. The analysis of whether any particular communication should be restricted, however, should also take into account the identity of the person who is distributing the information, opinions or recommendations in question. For example, while publication by research analysts generally should not be problematic, the dissemination of similar issuer-specific information by sales personnel might be of potentially greater concern, depending on facts and circumstances (as the latter is more likely to be subject to stricter scrutiny in this regard than a traditional research report, because of the likelihood that Rule 139 was intended principally to address the distribution of traditional research reports).
- 43 Rule 168 generally permits an issuer, at any time during the offering process, to issue regularly released "factual business information" and "forward-looking information." Factual business information (i) excludes information about the offering, (ii) may not be released as part of offering activities, and (iii) is limited to information about the company and its business, advertisements and other information about the company's products and services, and dividend information. Notably, the Rule 168 safe harbor is available only to the issuer, not the agent.
- 44 FINRA Rules, Rules 5110(b)(7)(C) and 5110(b)(7)(A), FINRA MANUAL. Although a filing may be required, FINRA's Public Offering System automatically handles well-known seasoned issuer shelf registration filings, which generally results in a same-day or in some cases immediate turnaround for such filings.
- 45 See The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).
- 46 See SEC, Division of Market Regulation, Staff Legal Bulletin No. 9 (Oct. 27, 1999; revised Apr. 12, 2002) Fed. Sec. L. Rep. (CCH) ¶60,002.
- 47 Where equity-linked securities—whether in the form of convertibles, exchangeables or warrants—are cash settled only, they are eligible for sale under Rule 144A irrespective of whether the linked security is listed on a U.S. exchange. That is because there is no underlying security being offered, so the issuer of the overlying security need not rely on Rule 144A (or any other exemption from Securities Act registration) for any security other than the overlying security. See *Mandatorily Exchangeable Issuer Securities* (avail. Oct. 18, 1999).
- 48 The other requirements of Rule 144A must also be met. See Chapter 7.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.03, BLOCK TRADES**

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 § 10.03 (11th and 12th Editions 2014-2017)

11th and 12th Editions

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Block trades are placements of large blocks of equity securities by an issuer or selling stockholder. In block trades, unlike traditional underwritten securities offerings, an underwriter commits to purchase the securities without the benefit of a marketing and book-building process, often after a competitive bidding process. <sup>[49]</sup> Accordingly, an underwriter in a block trade will typically contact investors and market the resale of the securities only after it and the issuer or selling stockholder have agreed upon a certain purchase price. <sup>[50]</sup>

### **[1] SEC Registered Blocks**

Registered block trades as an alternative to traditional underwritten offerings provide issuers and selling stockholders a number of benefits. These benefits primarily include speed of execution in terms of due diligence and documentation as described further below and, since the block trade is a "bought deal," greater certainty regarding the consummation of the transaction prior to public announcement. This certainty generally comes at a cost, however, requiring the issuer or selling stockholder to accept a greater discount to the prevailing market price.

The fact that an underwriter in a registered block trade first commits to purchase securities creates immense timing pressure for that underwriter in terms of publicly announcing and launching a block trade, as any delay in the underwriter's ability to resell the securities will increase the risk of fluctuations in the market price of the securities, which could result in adverse economic consequences for the underwriter. As a result of this timing pressure, block trades are generally executed shortly after the underwriter is chosen.

Despite this timing pressure, the issuer and the underwriter need to manage the risk of liability for disclosure in a registered offering in the United States under §§ 11 and 12(a)(2) of the Securities Act and Rule 10b-5 under the

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Exchange Act. <sup>[51]</sup> Prospective underwriters will often be able to conduct due diligence, including due diligence calls with management, simultaneously with other prospective underwriters during the bid process or, in certain circumstances, in separate, parallel sessions. To a large extent, since an underwriter will not be chosen in the bid process until just prior to launch, the underwriter will need to rely significantly on the issuer's designated underwriter's counsel and the issuer's auditors to establish its due diligence defense and prepare documentation in advance of launch. In addition, because of the limited time available to the underwriter to conduct due diligence, block trades will ideally launch shortly after the issuer's earnings release in order to reduce the risk that the issuer or selling stockholders have material, non-public information that would need to be disclosed to investors.

Issuers and selling stockholders typically offer securities in a registered block trade using a prospectus supplement filed in connection with a shelf takedown, so long as the issuer meets certain eligibility requirements. <sup>[52]</sup>

### **[2] Rule 144 Blocks**

Selling stockholders that are affiliates <sup>[53]</sup> of the issuer may also offer securities in block trades pursuant to the exemption from registration provided by Rule 144 under the Securities Act. Rule 144 block trades allow an affiliate to resell securities to the public without SEC registration, typically providing even faster execution and lower costs than a registered block trade. Securities purchased in a Rule 144 block trade, like securities purchased in a registered block trade, are not restricted and are thus freely transferable by non-affiliates.

Reliance on Rule 144, however, is subject to certain requirements, including holding periods for restricted securities and availability of information regarding the issuer. In addition, affiliates are subject to certain volume and manner of sale restrictions. Under Rule 144, affiliates may sell in any three-month period the greater of (i) 1% of the outstanding securities of the same class and (ii) average weekly trading volume on a U.S. exchange or automated interdealer

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quotation system or the consolidated tape during the prior four weeks. <sup>[54]</sup> With regard to the manner of sale restrictions, Rule 144 block trades are made directly to a market maker. <sup>[55]</sup> Although the market maker generally may not solicit interest in the block before it commits to purchase it, once the block is purchased, the market maker is free to solicit buy side investors. <sup>[56]</sup>

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### Footnotes

- 49 Underwriters in block trades, whether registered, Rule 144 eligible or of freely tradable securities, should be conscious of the requirements of the underwriting and market-making exemptions in the Volcker Rule (Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (2010) [codified at 12 U.S.C. § 1851]); in particular, taking into account the "reasonably expected near term demands of clients, customers, or counterparties," which are characterized differently for purposes of the two exemptions.
- 50 Block trades will often be made on a variable price reoffer basis. Instead of the offering documents providing a single, fixed price at which the securities are offered to investors, they will state that the underwriter has agreed to purchase the securities at a certain fixed price per share and that the underwriter will reoffer the securities from time to time at market prices or at negotiated prices that may vary. Underwriters often prefer this approach since they have very little time to market the resale of the securities after the launch of a block trade to determine a single, fixed price.
- 51 See § 11.03.
- 52 See § 3.02[2] for a discussion of shelf registration statements and shelf takedowns. In order to prepare the registered block trade as a shelf takedown, the issuer will need to be eligible to file a shelf registration statement on Form S-3 or F-3. Because of timing issues, the issuer will ideally have an effective shelf registration statement in advance of the block trade. An issuer that is a well-known seasoned issuer has greater flexibility since it is eligible to file an automatic shelf registration statement that is immediately effective upon filing.
- 53 An "affiliate," with respect to an issuer, is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." Rule 144(a)(1) under the Securities Act.
- 54 See § 7.03[2] for a more detailed discussion of the requirements of Rule 144.
- 55 For a definition of market maker, see § 7.03[2], Note 85.
- 56 See SEC Release No. 33-6099 (Aug. 2, 1979), 44 Fed. Reg. 46,752, 46,760, 46,762 (Aug. 8, 1979). Note that certain Rule 144 block trades may be determined to constitute a distribution in the United States for purposes of Regulation M, depending on the "magnitude of the offering" and the "presence of special selling efforts and selling methods." See § 7.10 for a discussion of Regulation M.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.04, UNDOCUMENTED OFFERINGS**

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 § 10.04 (11th and 12th Editions 2014-2017)

11th and 12th Editions

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A practice, not uncommon in Europe and Asia, has developed of effecting certain securities offerings, often by affiliates, and occasionally by the issuer itself, without providing a prospectus or other formal offering document to potential investors ("Undocumented Offerings"). Undocumented Offerings in Europe <sup>[57]</sup> and Asia are generally marketed exclusively to institutional investors, typically through telephone calls. Because secondary sales by affiliates do not trigger special requirements in most jurisdictions outside the United States, they can be conducted in a manner resembling other secondary market transactions, such as block trades. <sup>[58]</sup> The steps taken are largely dictated by the size of the transaction and the desire for speed of execution. The offerings generally are timed to coincide with (or follow closely on) an earnings release by the issuer and may be undertaken in conjunction with a road show or other presentation intended for the limited purpose of allowing potential investors to ask questions about the issuer. Salespeople involved in such marketing efforts use a "selling script" or other approved "fact sheet" intended to reduce the risk of investors receiving information other than that contained in the issuer's earnings release. Research reports, either already existent or prepared in contemplation of the Undocumented Offering, are sometimes provided to prospective investors. A purchaser is often asked to execute a letter (an "investor letter") acknowledging, among other things, that the offering is not being registered under the Securities Act, the investor has not received a prospectus or any other information about the issuer from the seller other than the earnings release and it is not relying on

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the seller in making its investment decision. The investor letter may also contain confirmation of the purchaser's status as an institutional investor. Finally, while the purchase agreement between the entity selling the securities and the broker-dealer is not of the scope of a typical underwriting agreement, "bare-bones" representations and warranties (and indemnification) are typically obtained from the seller, including a representation that the seller is not aware of any material nonpublic information about the issuer.

Although Undocumented Offerings provide a high degree of flexibility and efficiency, there is a risk of U.S. liability for material misstatements or omissions under Rule 10b-5. Oral statements by salespeople, research reports by distribution participants and press releases and, sometimes, statements at any road shows by the issuer can be sources of liability under Rule 10b-5 and take on added significance in the absence of a written prospectus. Due primarily to the risk of Rule 10b-5 liability, many U.S. banks in particular have been reluctant to engage in Undocumented Offerings in the United States. <sup>[59]</sup>

Those banks that do include U.S. investors in Undocumented Offerings typically have a screening process that analyzes each potential Undocumented Offering and its related risks. Not only is approval required before work on an Undocumented Offering can begin, <sup>[60]</sup> but also such offerings must be undertaken in accordance with established guidelines (including due diligence guidelines). Generally, the level of diligence performed and other measures taken will depend on the nature of the offering, with standard block trades on behalf of unaffiliated shareholders generally requiring only minimal diligence efforts and significant capital raising exercises by issuers and large sales by affiliates (especially those involving road shows and other marketing efforts) demanding more extensive diligence procedures.

The same considerations that apply to Rule 144A offerings and to traditional private placements relating to, among other things, research, publicity, the application of Regulation M and the Investment Company Act also

apply to Undocumented Offerings.

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#### Footnotes

- 57 The Prospectus Directive (Directive 2003/71/EC, as amended, including by Directive 2010/73/EU), as implemented by member states of the European Union, provides exemptions from the requirement to publish a prospectus for certain public offers or for the admission to trading of securities on an EEA regulated market under certain circumstances.
- 58 See § 10.05.
- 59 Undocumented Offerings in the United States by an issuer, an affiliate or of restricted securities must be exempt from registration under the Securities Act. For a discussion of the relevant exemptions, see Chapter Z.
- 60 In determining whether an Undocumented Offering is appropriate, the following issues, among others, may be relevant: (i) the identity of the seller, (ii) the contractual arrangements with the seller, (iii) the investment bank's relationship with the issuer, (iv) the nature of the market for the issuer's securities and the amount of publicly available current information about the issuer, such as in relation to any significant recent corporate transactions involving the issuer, and (v) the nature of the selling efforts.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.05, RIGHTS OFFERINGS**

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 § 10.05 (11th and 12th Editions 2014-2017)

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When raising additional capital through the sale of equity, many foreign companies elect or are required under their home-country laws to offer existing shareholders rights to purchase additional shares in proportion to their current percentage of share ownership. Rights offerings have provided a means for companies to raise additional capital to, among other things, fund acquisitions or to support liquidity. During the financial crisis in 2008 and 2009, rights offerings were a popular means of raising capital. <sup>[61]</sup> European financial institutions, such as The Royal Bank of Scotland, HBOS, Société Générale and UBS in particular, sought to bolster liquidity and capital ratios through new issuances of shares in the wake of significant losses on bad debts and complex debt securities. <sup>[62]</sup> In the case of HBOS, the rights offering proved unsuccessful, and the company was later acquired by Lloyds TSB. <sup>[63]</sup>

A foreign company with U.S. shareholders generally has the following options with respect to shares offered to U.S. shareholders through rights offerings: register the shares offered to U.S. shareholders, utilize the exemption from the registration requirements provided by Rule 801 under the Securities Act (if available) or exclude some or all U.S. holders from participating. <sup>[64]</sup> Which course of action a foreign company follows is influenced by the requirements of its home-country laws and by whether it is already a reporting company under the Exchange Act. The laws of many countries, for example those of the United

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Kingdom, require that rights to shares be offered to all shareholders, on a preemptive basis in proportion to their existing holdings, unless the shareholders have disappplied their statutory preemption rights. <sup>[65]</sup> In circumstances where statutory preemptive rights have not been disappplied in the context of a U.K. issuer, such issuer may choose, by means of a notice published in the London Gazette, to offer rights only to shareholders that have a registered address in the European Economic Area or have provided the issuer with an address in the European Economic Area. <sup>[66]</sup> This manner of offering rights should permit compliance with U.K. statutory requirements while not constituting an offer of securities in the United States requiring registration under the Securities Act. In contrast, Russian law requires that new shares issued by a joint-stock company be allocated to every shareholder that provides a completed subscription form for new shares, which is likely to involve offers and sales that would not be consistent with the private placement exemption provided by § 4(a)(2) of the Securities Act. <sup>[67]</sup> Where U.S. holders hold shares in the form of depositary receipts, however, it is possible to exclude ineligible U.S. holders through instructions to the Depositary regarding the distribution of rights and new shares to holders of depositary receipts. <sup>[68]</sup>

### **[1] Registration Under the Securities Act**

The advantage of registering shares offered to U.S. shareholders in a rights offering is that rights may be extended to, and exercised by, all U.S. shareholders, including retail holders, which in turn means this option creates the least tension with home-country laws that may require equal treatment of shareholders. If the foreign issuer is a reporting company under the Exchange Act, then it may, if it has been required to file reports with the SEC under the Exchange Act for

at least 12 months (providing that all reports required to be filed have been filed in a timely fashion) and otherwise meets certain eligibility requirements, register the offering on Form F-3, a short-form registration statement that incorporates by reference the company's business description and financial statements from its annual report on Form 20-F. <sup>[69]</sup> The company would need to include or incorporate in a registration statement covering a rights offering financial statements with the financial information called for by Item 18 of Form 20-F. <sup>[70]</sup> Thus, registration is much easier for a reporting company, provided that the registration statement is not reviewed by the SEC or can be reviewed and declared effective prior to the beginning of the offering period. <sup>[71]</sup> In particular, the registration process for rights offerings by foreign issuers that qualify as well-known seasoned issuers is facilitated by the use of automatic shelf registration statements, which are not subject to SEC review and are immediately effective upon filing. Accordingly, without the prospect of SEC review of the registration statement and the timing implications this review can create for rights offerings on a short timetable under home-country laws (as discussed further below), an important structural obstacle to registering a rights offering is removed for foreign well-known seasoned issuers.

Registration solely for the purpose of conducting a rights offering is not often an attractive option for foreign issuers that are not already reporting companies, as the registration process is time-consuming, labor-intensive and expensive. Registration entails potentially onerous continuing obligations for the issuer. <sup>[72]</sup> Further, the liability regime is stricter in a registered offering than a private placement, with strict liability for the issuer with regard to material misstatements in or omissions from disclosure, and also a higher level of liability exposure for directors and management of the issuer and other offering participants. <sup>[73]</sup> If the issuer's home country laws can accommodate exclusion of U.S.

retail holders, the benefit of including those holders is often perceived to be outweighed by the costs of registration (both actual, in terms of the registration process, and potential, in terms of increased liability). For these reasons, multi-jurisdictional rights offerings by non-U.S. companies are rarely conducted as registered offerings in the United States unless the issuer is already a U.S. reporting company. Differences in home-country and U.S. disclosure standards, such as with regard to non-GAAP financial measures, disclosure requirements related to business combinations and complexities with supplemental disclosures not required by Form 20-F (e.g., inclusion of projections as mandated by local law), may also make a registered offering unattractive.

Non-U.S. companies, even if they are U.S. reporting companies, may also face challenges of coordinating timing and settlement as a result of different regulatory regimes and clearing systems in the United States and their home country. Under New York Stock Exchange rules, for example, notice of a rights offering must be provided to the Exchange and written notice must be sent to holders of NYSE-listed shares at least ten days in advance of the proposed record date <sup>[74]</sup> and the subscription period must extend at least 16 days after mailing of the rights offering prospectus to holders of record. <sup>[75]</sup> In situations in which issuers do not mind providing the ten-day advance notice and having the minimum subscription periods mandated by the applicable U.S. securities exchange, such as where home-country laws are more demanding, these rules generally do not present a problem. <sup>[76]</sup> However, in situations where advance notice requirements or minimum subscription and settlement periods are shorter or non-existent under home-country laws and exchange requirements, well-known seasoned issuers may conclude that the potential benefits of extending their rights offerings to U.S. investors are outweighed by the potential inconvenience and market risk associated with complying with the timing requirements applicable in the

United States. <sup>[77]</sup> In such cases, issuers may decide to prohibit the exercise of subscription rights by U.S. shareholders, reasoning that the interests of U.S. shareholders will be sufficiently protected through the sale for cash in the market by ADR depositaries of the rights belonging to U.S. shareholders. <sup>[78]</sup> Separate procedural complications would apply if the issuer wishes to have the rights themselves traded on an exchange in the

United States as well as on its home market exchange.

As markets move away from the delivery of paper rights offering subscription materials and rely more heavily on "access equals delivery" concepts, <sup>[79]</sup> rules and practices in the United States governing rights offering timetables may come to be revisited, particularly for foreign private issuers that qualify as well-known seasoned issuers. [Approaches seeking to ensure that the least sophisticated U.S. investors receive paper notification of an opportunity to participate in a non-U.S. rights offering—and thus continue to impose burdensome requirements on the issuer—may eventually be revised if the conclusion is that, in practical terms, they are resulting in all U.S. investors being excluded from participation in rights offerings by foreign issuers. <sup>[80]</sup>

## [2] Rights Offerings in Reliance on Rule 801

In 1999, the SEC adopted a new exemption to its registration requirements in order to facilitate cross-border rights offerings by non-U.S. companies, and in September 2008, the SEC adopted changes expanding and enhancing the cross-border exemptions adopted in 1999. <sup>[81]</sup> Rule 801 under the Securities Act provides foreign private issuers <sup>[82]</sup> with a nonexclusive exemption from the

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registration requirements of the Securities Act for rights offerings of equity securities in the United States if 10% <sup>[83]</sup> or less of the class of securities being issued is held of record by U.S. holders. <sup>[84]</sup>

Rule 801 is available only for all-cash rights offerings made on a *pro rata* basis to all holders of the same class of securities, including holders of ADRs evidencing those securities. <sup>[85]</sup> The rights granted to U.S. shareholders in an offering in reliance on Rule 801 are not freely transferable except outside the United States pursuant to Regulation S under the Securities Act, <sup>[86]</sup> but the securities to be purchased through the exercise of rights are freely transferable in the United

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States to the extent the underlying securities that gave rise to the rights are unrestricted securities. <sup>[87]</sup> The exemption is also available to issuers only, and is therefore not available for underwriters in connection with a placement of shares for which the corresponding rights are not exercised by shareholders, commonly referred to as "rump" shares.

Rule 801 does not require that any specific disclosure be delivered to U.S. shareholders, except that U.S. shareholders must be provided contemporaneously the same information the issuer provides to offerees in its home jurisdiction translated into English. If the issuer disseminates information solely by publication in its home country, publication of the rights offering is also sufficient in the United States if the information is published in a manner reasonably calculated to inform U.S. shareholders of the offer.

In addition, any materials used abroad must be submitted to the SEC on Form CB. <sup>[88]</sup> Because Form CB is submitted to, rather than filed with, the SEC, the issuer does not have liability for the offering materials under § 11 of the Securities Act or § 18 of the Exchange Act, although the issuer and offering participants remain liable under § 12(a)(2) of the Securities Act and § 10(b) of the Exchange Act and the other antifraud provisions of the U.S. securities laws. The issuer is also required to appoint an agent for service of process in the United States on Form F-X.

In principle, the foreign issuer will also have to comply with applicable state securities laws, including antifraud provisions under state securities laws. State securities laws ordinarily require that an issuer register with state authorities any offering of securities made to state residents. It is likely, however, that one or more exemptions from registration will be available in many states to an issuer making a Rule 801 rights offering, such as the exemption for offers to institutions.

## [3] Private Placements Under Section 4(a)(2) of the Securities Act



For those foreign companies for which registering shares is not practicable or for which the Rule 801 exemption is unavailable, the offer of shares to existing shareholders in the United States may be structured as a private placement under § 4(a)(2) of the Securities Act, limiting participation, to the extent permitted by home-country law, in the United States to institutional shareholders

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generally that can certify they are qualified institutional buyers. <sup>1901</sup> In such rights offerings, ineligible U.S. holders do not receive rights or new shares and instead, where permitted, their rights (if transferable) are sold in the market and the net proceeds are allocated to the ineligible holders. The new shares received upon exercise by eligible U.S. holders are "restricted securities" for purposes of Rule 144 under the Securities Act and cannot be resold in the United States for the applicable restricted period thereunder except pursuant to an effective registration statement or an exemption from the registration requirements.

### **[a] Non-Fungible Securities**

If the new shares issued upon exercise of the rights are not fungible with a class of shares listed on a U.S. exchange or quoted on a U.S. automated inter-dealer quotation system, the private placement of rights to U.S. holders will be analogous to an offering in reliance on Rule 144A under the Securities Act, with some additional procedures based on the procedures developed for private placements in reliance on Regulation D under the Securities Act to ensure the offering is limited to eligible U.S. holders. <sup>1901</sup> Some of these procedures may not be needed if the placement is limited to qualified institutional buyers only. Eligible U.S. holders must first be identified through pre-certification by U.S. holders ( *i.e.*, by obtaining pre-screening letters from U.S. holders confirming their status as qualified institutional buyers before the holders are provided with any information or documentation for the offering) and/or pre-identification by the issuer with assistance from the underwriters (if any) to the offering ( *i.e.*, by comparing a list of registered holders to pre-screened lists of qualified institutional buyers maintained by an investment bank). Only those U.S. holders that provide an executed investor letter certifying their status as qualified institutional buyers along with a subscription form may exercise rights. Where possible, an issuer and/or rights offering subscription agent will need to work with the relevant clearing agencies

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and other intermediaries to prevent the distribution of rights and offering documentation to ineligible holders. In certain jurisdictions, such as Denmark, the clearing system may not be able to prevent the distribution of rights to holders' accounts identified as ineligible for participation in the rights offering, but may be able to prevent the distribution of shares to ineligible holders' accounts should those holders exercise rights.

### **[b] Fungible Securities and ADRs**

A private placement of rights for shares that are of the same class as shares listed on a U.S. exchange or quoted on a U.S. automated inter-dealer quotation system may follow the same procedures as those outlined above for rights offerings of non-fungible securities. However, the rights (if transferable) and new shares will not be eligible for resale under Rule 144A, and eligible U.S. holders must undertake to resell the rights and new shares only in offshore transactions in reliance on Regulation S.

If the foreign company has a sponsored ADR program in the United States and decides not to register the shares, it usually will instruct the Depositary to allocate rights to ADR holders that provide certifications as to their eligibility to participate in the rights offering ( *i.e.*, the same certifications as included in the investor letter described above), and sell, on behalf of excluded ADR holders, the rights to which such ADR holders would have been entitled, and to remit to them the net proceeds, after deducting any costs incurred in connection with the sale. <sup>1911</sup> If the shares or ADRs are listed on a stock exchange in the United States, the exchange's consent may be needed if some or all U.S. holders are to be excluded. <sup>1921</sup> Such consent has not been difficult to obtain in the past.

Holders receiving new shares upon exercise of rights in a private placement will be restricted from depositing the new shares for ADRs for so long as the shares are "restricted securities" for purposes of Rule 144 under the Securities Act. Accordingly, ADR holders exercising rights will receive new shares in the form of shares, not in the form of ADRs. In addition, for 40 days after the start of the subscription period for the rights offering, any shareholder wishing to deposit shares for ADRs will be required to certify that the shares to be deposited were not acquired on or after the date the new shares were issued in the

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rights offering (*i.e.*, that the shares are not the "new," restricted shares). Alternatively, the Depositary may close the ADR facility to new deposits for 40 days after the start of the subscription period for the rights offering. <sup>193</sup>

## **[c] Publicity**

While the amendments to Rule 144A eliminating the prohibition on "general solicitation and general advertising" liberalized restrictions on publicity in the context of offerings in reliance on Rule 144A, these new rules do not change the prohibition on "general solicitation and general advertising" in the context of a private placement in reliance on § 4(a)(2) of the Securities Act. <sup>194</sup> Accordingly, publicity restrictions will need to be implemented by the issuer and offering participants in order to ensure no "general solicitation or general advertising" with respect to the rights offering in the United States. <sup>195</sup> The issuer should be able to continue to issue press releases and make disclosures to the market in the ordinary course; however, restrictions on the content and distribution of such releases will be required to the extent a press release or announcement includes information regarding the offering. The content of websites (*i.e.*, the issuer's website, the rights offering subscription or information agent's website or any other offering participant's website on which information and materials regarding the offering are posted) should be similarly monitored, and access from the United States or by U.S. persons, as appropriate, to press releases and other materials relating to the offering posted to websites restricted. <sup>196</sup>

If the foreign company is a reporting company under the Exchange Act, special consideration must be given to disclosures in the United States regarding the rights offering, given the requirements, on the one hand, of Form 6-K, and, on the other hand, the prohibition on "general solicitation and general advertising" applicable to private placements in the United States conducted in reliance on § 4(a)(2) of the Securities Act. Form 6-K requires a foreign issuer to furnish to the SEC on Form 6-K significant information about the issuer and its

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subsidiaries that (i) must be made public in its country of domicile or incorporation pursuant to the law of that country, (ii) is filed with any foreign stock exchange on which its securities are listed and made public by such exchange or (iii) is distributed to its securityholders. <sup>197</sup> A public announcement of a rights offering made by a foreign issuer in its home country and also the rights offering prospectus distributed to its shareholders would fall within these categories. However, furnishing the press release (to the extent the announcement includes information beyond the scope of Rule 135c under the Securities Act) and the rights offering prospectus on Form 6-K would make information about the offering publicly available to persons not eligible to participate in the rights offering in the United States. <sup>198</sup> To address this potential conflict between the requirements of Form 6-K and restrictions on publicity in the private placement context, a common approach is for foreign issuers to (i) prepare and release in the United States, and furnish to the SEC on Form 6-K, a separate announcement of the rights offering in accordance with Rule 135c under the Securities Act and (ii) furnish on Form 6-K information included in the rights offering prospectus that may be material to investors in the United States and that has not been previously made public by the issuer, but excluding offering-specific information included in the prospectus and relevant only to offerees, such as the terms and conditions of the offering and subscription process. <sup>199</sup>

## **[4] Exclusion of U.S. Holders**

Where the options described above are not available or feasible for a foreign company conducting a rights offering, the company may elect to exclude all

U.S. holders from participating. In this case, generally, the rights, if transferable, or new shares allocable to the excluded U.S. holders are sold in the open market and the net proceeds remitted to such holders. <sup>[100]</sup> This may be disadvantageous to the excluded U.S. holders. Not only are their interests in the company diluted, but also the cash received may not be equivalent in value to the lost opportunity to subscribe.

If U.S. holders are excluded, the rights offering may be structured in reliance on Regulation S. Rights offerings by foreign issuers are not dealt with specifically in Regulation S but can be made to fit into its framework. The only complicating feature is that there are no "distributors" because the issuer offers the new securities directly to holders of outstanding securities. <sup>[101]</sup> Accordingly, in the case of offerings under Category 1 of Regulation S, the issuer itself must ensure that the "offshore transaction" requirement is met, and in addition, in those rare instances where a rights offering by a foreign issuer falls into Category 2 or Category 3 of Regulation S, that the purchasers are not U.S. persons. This generally can be done by requiring persons taking up their rights to make an appropriate certification, unless such a requirement is inconsistent with foreign laws requiring that all shareholders be treated the same. Publicity restrictions, identical to those described above in § 10.07[3][c], will need to be implemented in order to ensure no "directed selling efforts" in the United States. <sup>[102]</sup>

Because there are no distributors, the prohibitions on U.S. offers and sales during any applicable distribution compliance period become moot. Therefore, the securities offered and sold outside the United States pursuant to the exercise of the rights (but not the rights themselves) should trade freely into the United States, subject to the 40-day limitation of § 4(a)(3) of the Securities Act in the case of sales by dealers. <sup>[103]</sup>

## [5] Additional Practical Considerations

In the rights offerings of 2008 and 2009, certain trends emerged reflecting the financial distress of issuers and a risk-averse underwriting environment.

"Soft" underwriting agreements entered into prior to announcement of the rights offering became commonplace. These agreements, often in the form of a letter, are a commitment by the underwriters to enter into an underwriting agreement to purchase and conduct a placement of any "rump" shares, subject to certain conditions being met and termination rights. For an issuer in financial distress, the underwriting commitment is an important message to shareholders that the capital to be raised by the rights offering is in place regardless of the level of subscription by shareholders. This "soft" underwriting commitment is replaced by a full underwriting agreement at the launch of the rights offering. One of the conditions included in these agreements may be that certain principal shareholders subscribe for, and exercise, rights allocated to them and/or take up all or part of the "rump" shares. The underwriters then may agree to purchase the remainder of the "rump" shares not attributable to the principal shareholders.

The underwriters' termination rights, <sup>[104]</sup> and the length of the period in which the underwriters may exercise their termination rights, has been a particular point of focus in rights offerings. While it is in the underwriters' interest to maintain the ability to exercise their termination rights for as long as possible ( *i.e.*, up until the date on which any "rump" shares are delivered to the underwriters), it is in the issuer's interest to have this period be as short as possible. Principal shareholders who have committed to subscribe for, and exercise, their rights, may not view favorably arrangements in which the underwriters may terminate their commitment after the point at which shareholders' subscription rights are irrevocable (which is usually the end of the subscription period, depending on home-country law). If the rights are traded on an exchange, home-country regulators and stock exchange rules may also influence the length of the period during which the underwriters may terminate their underwriting commitment. For example, regulators in the United Kingdom have taken the view that once the rights, referred to as "nil paid shares" (as rights are received by the shareholder at no cost to the shareholder), are listed and begin trading, the rights

offering cannot be revoked because securities are not eligible for listing on a conditional basis. Accordingly, in underwriting agreements for rights offerings of shares admitted to trading in the United Kingdom, the underwriters' termination rights may not be exercised after the rights have been admitted to trading. Outside the United Kingdom there is some variability in practice with respect to the length of the period in which the underwriters may exercise their termination rights, although the period typically ends on a date between the end of the subscription period and the date on which the shares are delivered to holders.

A common feature of rights offerings in certain countries, in particular the United Kingdom, is the use of "sub-underwriters" in relation to underwritten rights offerings. Underwriters of such offerings often seek to obtain the commitment of large institutional investors to assume a portion of the underwriting risk and enter into sub-underwriting agreements with such investors before a rights offering is announced, typically in exchange for a fee. These arrangements would raise a number of issues if made in the United States, especially in relation to a rights offering that will be registered in the United States ( e.g., issues under the registration requirements of the Securities Act, such as the inability to contact investors before a public filing is made in the United States, and under the Exchange Act, such as whether the sub-underwriters might be considered to be engaging in broker-dealer activities as a result of performing a sub-underwriting role (an issue to consider even if the rights offering is being conducted privately in the United States), as well as several other potential regulatory issues).

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#### Footnotes

- 61 Due to the volume of rights offerings in the U.K. market in the spring and summer of 2008, the Chancellor of the Exchequer commissioned an industry group, known as the Rights Issue Review Group (the "U.K. Rights Issue Review Group"), co-chaired by the Financial Services Authority and HM Treasury, to review the rights offering process and issue a report with proposals for reform, which the U.K. Rights Issue Review Group did in November 2008. The U.K. Rights Issue Review Group estimated that £23 billion was raised through rights offerings in the United Kingdom in 2008, of which £16.9 billion was by companies in the financial industry. THE RIGHTS ISSUE REVIEW GROUP, A REPORT TO THE CHANCELLOR OF THE EXCHEQUER BY THE RIGHTS ISSUE REVIEW GROUP, at 3, 5 (Nov. 2008) (the "Rights Issue Review Group Report").
- 62 See Peter Thal Larsen, *Response to Rights Issues Turns Lukewarm*, FINANCIAL TIMES, May 14, 2008.
- 63 See Jane Croft, *HBOS Suffers Big Blow Over Rights Issue*, FINANCIAL TIMES, July 22, 2008. Only 8.29% of shareholders subscribed for new shares in the HBOS rights offering. The Rights Issue Review Group Report, at 6.
- 64 If some of the U.S. holders are institutions, and it is permissible under local law to treat shareholders differently, the issuer may allow the U.S. institutions to receive and exercise rights, relying on the private placement exemption provided by § 4(a)(2) of the Securities Act. The institutions can then, if they wish, resell the securities abroad under Regulation S. See § 10.07[3].
- Rights are not typically offered to existing shareholders for value. Accordingly, their issuance should not be considered an "offer" or "sale" requiring registration under the Securities Act. The exercise of such rights and the receipt of new shares, which typically is for value, do however require registration or exclusion of U.S. holders.
- 65 §§ 560 to 577 of the Companies Act 2006.
- 66 §§ 562(3) of the Companies Act 2006.
- 67 In particular, according to Article 40 of the Federal Law of the Russian Federation "On Joint-Stock Companies" No. 208-FZ, dated December 26, 1995 (as amended), each shareholder has a pre-emptive right to purchase a number of additional shares or securities convertible into shares issued by way of open subscription ( i.e., placement of securities among an unlimited number of investors) *pro rata* to its existing shareholding in the company. Even if the shares or securities convertible into shares are issued by way of closed subscription ( i.e., placement of securities among a limited group of investors), existing shareholders will have similar pre-emptive rights unless they vote for the issue or disapply their pre-emptive right. Due to

these requirements of Russian law, it may not be possible to exclude U.S. shareholders completely from participating in a rights offering by a Russian company. A joint-stock company may not be able to refuse to sell shares or securities convertible into shares to a shareholder that duly exercised its pre-emptive rights, and prior to expiry of the pre-emptive right period, a company may not be able to offer such securities to other investors. Article 41 of the Federal Law of the Russian Federation "On Joint-Stock Companies" No. 208-FZ, dated December 26, 1995 (as amended).

68 See § 10.07[3][b].

69 See § 3.02[2][b].

70 Form F-3, General Instruction I.B.4. If the rights offering registration statement was going to be used in connection with standby underwriting arrangements, under which one or more broker-dealers agree with the issuer to purchase and distribute any shares not acquired from the issuer through the exercise of rights, the issuer must also meet the \$75 million public float requirement. See Form F-3, General Instruction I.B.1.

71 The elimination of the ability of foreign issuers to make confidential filings with the SEC, other than in limited circumstances, has further discouraged the inclusion of U.S. holders in such issuers' rights offerings, as issuers are reluctant to signal to the market impending rights offerings through the U.S. public filing and review process. The SEC is hopeful that foreign well-known seasoned issuers will use automatic shelf registration for rights offerings. However, a potential rights issuer in financial distress may not be able to meet the \$700 million common equity worldwide market value requirement for well-known seasoned issuers.

72 [Add cross-ref to discussion of ongoing obligations of being a U.S. public company.]

73 § 11(a) of the Securities Act; see also § 11.03[1].

74 NYSE LISTED COMPANY MANUAL § 703.03(B) and (C). Requests for an abbreviated notice period are considered on a case-by-case basis. See also Rule 10b-17(b) under the Exchange Act, which sets the basic standards for prior notice of record dates. The NASDAQ listed company rules do not include notice requirements to holders, although at least 15 calendar days' notice to the Exchange is required for issuances of common stock in a transaction that may result in the potential issuance of common stock greater than 10% of either the total shares outstanding or voting power outstanding on a pre-transaction basis (except for a company solely listing ADRs). See NASDAQ Listing Rule 5250(e)(2)(D), NASDAQ MANUAL.

75 NYSE LISTED COMPANY MANUAL § 703.03(E). The Exchange allows for shorter subscription periods of 14 days if arrangements are made to expedite the distribution of rights and to facilitate their exercise. The NASDAQ listing rules do not specify a minimum subscription period.

76 The NYSE rules also require that all known terms of a proposed rights offering be publicly released immediately after an issuer's Board of Directors has taken action, and that additional terms be publicly released as soon as they are determined. NYSE LISTED COMPANY MANUAL § 703.03(B).

77 In the United Kingdom, for example, the U.K. listing rules do not require that there be ten days' prior notice of the record date for a rights offering, and the minimum subscription period is ten U.K. business days. As a result, a rights offering limited to following the U.K. rules can be completed more quickly from date of announcement than it can be if it is extended to the United States. In our experience, the NYSE has been receptive to discussion with foreign private issuers of ways of reconciling differing timing requirements.

78 This reasoning does not apply if the rights are non-transferable. Limitations on the exercise of rights by particular groups of holders may require an analysis of shareholder equal treatment rules applicable to an issuer in its home country or under the rules of other relevant exchanges. See *supra* Notes 65–67 and accompanying text; see also § 10.07[4].

79 See Rule 173 under the Securities Act; SEC Release No. 33-8591 (July 19, 2005).

80 In the United States, traditional shareholder communications channels tend to be constructed with proxy communications in mind, which typically move at a more languid pace than price-sensitive capital markets transactions. For a variety of reasons, rights offerings have not been as popular with investors in the United

States as they have been in Europe over the past several decades, with the result that there is less impetus for the acceleration of procedures.

- 81 Rule 801 under the Securities Act; see SEC Release No. 33-7759 (Oct. 22, 1999) and SEC Release No. 33-8957 (Sept. 19, 2008) (the "2008 Cross-Border Amendments").
- 82 See § 3.01, Note 1 for the definition of foreign private issuer.
- 83 For purposes of calculating the percentage of outstanding shares held by U.S. holders, effective with the 2008 Cross-Border Amendments, shares held by any U.S. or non-U.S. holder owning 10% or more of the class of shares are now included in the number of shares outstanding. Treasury shares are excluded from the calculation of shares held by U.S. holders and the total number of securities outstanding. Securities underlying ADRs must be included in determining the amount of securities outstanding of the class subject to the rights offering, as well as in the calculation of U.S. holders. The SEC did not adopt a proposed rebuttable presumption that persons holding through ADR facilities are U.S. holders. Other types of securities that are convertible into or exchangeable for subject securities, such as warrants, options or convertible securities, are not taken into account in calculating U.S. ownership. Rule 800(h)(2) under the Securities Act.
- 84 In determining U.S. ownership, the issuer is required to "look through" the record ownership of certain brokers, dealers, banks or nominees appearing on the issuer's books or transfer agents, depositaries or others acting on the issuer's behalf. These "look through" requirements apply only to securities held of record (i) in the United States, (ii) in the issuer's home jurisdiction or (iii) in the primary trading market for the issuer's securities if different from the issuer's home jurisdiction. The issuer's calculation of U.S. ownership may be made as of any date that is no more than 60 days before, and no more than 30 days after, the record date of the rights offering. Rule 800(h)(1) under the Securities Act. The focus on a range of dates reflects the difficulties offering participants had under the prior rules obtaining information as of a specific date. The SEC also adopted an alternative eligibility test in the 2008 Cross-Border Amendments, if the issuer is "unable to conduct" the look-through analysis described above, based on a comparison of the average daily trading volume of the subject class of securities in the United States to worldwide average daily trading volume. Rule 800(h)(7) under the Securities Act. The SEC did not define what is meant by the phrase "unable to conduct," indicating that the inability would need to be assessed based on the facts and circumstances of the particular transaction, but noted that the need to dedicate time and resources to conducting the look-through analysis and concerns about the completeness and accuracy of the information obtained from the analysis would not necessarily justify the use of the alternate test. In each instance, the issuer must make a good faith effort to conduct a reasonable inquiry into ascertaining the level of U.S. beneficial ownership. In addition, in certain jurisdictions, nominees may be prohibited by law (such as bank secrecy laws) from disclosing information about the beneficial owners on whose behalf they hold. Where nominees are prohibited by law from disclosing the country of residence of the beneficial owners of the subject securities, the SEC noted that the alternate test for determining eligibility should be available. SEC Release No. 33-8957 (Sept. 19, 2008), 73 Fed. Reg. 60,050, 60,057 (Oct. 9, 2008). See § 9.05[9][a].
- 85 The issuer need not, however, make the rights offering available to U.S. holders in a state that would require the rights to be registered. Rule 801(a)(3) under the Securities Act.
- 86 Rule 801(a)(6) under the Securities Act. This rule permits a U.S. recipient of the rights to sell them, for example, through a "designated offshore securities market" pursuant to Rule 904 under the Securities Act. See § 8.02[2].
- 87 Conversely, to the extent the underlying securities are "restricted securities" within the meaning of Rule 144 under the Securities Act, the securities purchased through the exercise of rights are also "restricted securities."
- 88 Form CB consists of a cover page, the attached offering materials and exhibits containing any information provided in the home jurisdiction or incorporated by reference in the home jurisdiction documents. The exhibits are not required to be sent to U.S. shareholders, unless they are sent to shareholders in the home jurisdiction.

- 89 While a private placement of rights structured in reliance on Regulation D would allow offers to U.S. holders who are "accredited investors"—a broader category of investors than qualified institutional buyers—this flexibility is rarely used in rights offerings, likely because the additional burden of complying with Regulation D is not justified as a practical matter.
- Foreign companies should consider the need to comply with the broker-dealer registration requirements under the Exchange Act in relation to contacts in rights offerings with U.S. investors that are not intermediated by a U.S. registered broker-dealer. This may arise, for example, where investment banks involved in a rights offering elect not to be involved in any U.S. portion of an offering due to liability considerations (e.g., where due diligence procedures customary for a U.S. offering may not be possible due to timing or other considerations). In this context, the safe harbor from the broker-dealer registration requirements contained in Rule 3a4-1 under the Exchange Act might be available.
- 90 See § 7.02[2].
- 91 Under the laws of some jurisdictions, rights may not be transferable. Under Mexican law, for example, preemptive rights may not be traded separately from the underlying shares that give rise to such rights. In this situation, ADR holders will not receive anything if the foreign company decides not to register the shares.
- 92 Listing agreements entered into by foreign issuers with the NYSE may direct such issuers to adhere to the NYSE's policy of not excluding U.S. holders from rights offerings while indicating that the NYSE has granted relief from this policy in the past and will continue to consider such relief on a case-by-case basis.
- 93 The 40-day period derives from § 4(a)(3) of the Securities Act. In a rights offering, the 40-day period of § 4(a)(3)(A) begins the day that existing shareholders are *first able* to apply to subscribe for the shares.
- 94 See § 7.02[3][b]. In the adopting release for the rule changes permitting "general solicitation and general advertising" in the context of offerings in reliance on Rule 144A, the staff stated that "an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)." SEC Release No. 33-9415 (July 10, 2013), 78 Fed. Reg. 44,771, 44,774 (July 24, 2013).
- 95 See § 7.02[3][b]. As mentioned below, similar restrictions will apply in respect of the portion of the offering outside the United States pursuant to Regulation S.
- 96 See § 7.02[5].
- 97 See § 4.02[3][c][iii].
- 98 Note that in the context of an offering pursuant to Regulation S, publication by an issuer of a notice in accordance with Rule 135c under the Securities Act does not constitute directed selling efforts. Rule 902(c)(3)(vi) under the Securities Act. Further, advertisements required to be published under foreign law or the rules of any foreign regulatory or self-regulatory authority do not constitute directed selling efforts for purposes of Regulation S. Rule 902(c)(3)(i) under the Securities Act. See § 8.02[1][b].
- 99 Prior to the amendments to Rule 144A that eliminated the prohibition on "general solicitation and general advertising" in the context of offerings in reliance on Rule 144A, the SEC staff took the position that the filing of the complete offering memorandum used in connection with an exempt offering under Regulation S and Rule 144A on Form 8-K during the exempt offering period would be inconsistent with the exemptions. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question 139.32 (Mar. 4, 2011). This position likely still applies to private placements in reliance on § 4(a)(2) of the Securities Act, given that "general solicitation and general advertising" are still prohibited in such transactions.
- 100 This process may be managed by an investment bank appointed by the issuer to act as "rights offering agent" for the purpose of coordinating distribution and collection of subscription forms, liaising with clearing systems and selling the rights and shares allocable to ineligible holders.
- 101 In the case of an underwritten rights offering, the restrictions of Regulation S apply to the underwriting just

as they do to any standard underwritten offering. Furthermore, in a case where an underwriter has contractually agreed to purchase any "rump" shares, those shares will also constitute allotment securities and (unless registered under the Securities Act or otherwise subject to an exemption from the registration requirements thereof) will be subject to restrictions on distribution.

102 See § 8.02[1][b].

103 See *supra* Note 93.

104 The scope of termination rights for material adverse changes in the business and financial condition of the issuer received considerable attention in the rights offerings of 2008 and 2009, given the volatility of the markets and the high risk that the circumstances of the company may change between the launch of the rights offering and the end of the subscription period. For these reasons, underwriters were considerably risk averse and sought to expand the definition of "material adverse change" in underwriting agreements, in some cases including ratings downgrades and non-routine engagements between the issuer and regulators and central banks. The U.K. Rights Issue Review Group identified concerns by issuers of the "creeping scope" of such clauses, although noting that the substance of an underwriting agreement is fundamentally a commercial matter and not a regulatory matter. Rights Issue Review Group Report, at 37–38.



## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.06, CONVERTIBLE AND EXCHANGEABLE SECURITIES**

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 § 10.06 (11th and 12th Editions 2014-2017)

11th and 12th Editions

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Convertible and exchangeable securities are equity-linked financial instruments that generally involve the issuance of a debt security convertible or exchangeable into common stock, or its cash equivalent. <sup>[105]</sup> The distinction between convertible and exchangeable securities is that convertible securities are issued by and convertible into common stock of the same issuer, and exchangeable securities are issued by an issuer that is different from the issuer of the common stock into which the securities are exchangeable. The debt security may be convertible or exchangeable at the option of the holder into a specified number of shares or, in certain cases, into a combination of shares and cash equal to the value of the balance of the shares at the issuer's election. Alternatively, the debt

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security may be mandatorily convertible or exchangeable, meaning that the security is automatically converted into or exchanged for the underlying common stock (or a cash equivalent) on the maturity date or upon the occurrence of certain specified events. The holder of a mandatorily convertible or exchangeable security would take delivery of a variable number of shares of common stock or the cash equivalent of those shares as determined by a formula. <sup>[106]</sup> During the term of the security, the holder also receives a current (generally) fixed coupon. <sup>[107]</sup> The issuer of the convertible or exchangeable security usually has the right to elect to cash settle the security by delivering, in lieu of shares, cash in an amount equal to the value of the underlying stock deliverable at maturity. <sup>[108]</sup>

During the term of an exchangeable security, the issuer retains all shareholder rights over the underlying shares and generally is not required to pledge the shares to the holders; the exchangeable security also imposes no limitations on the issuer's right to dispose of the shares to other purchasers. <sup>[109]</sup> In some cases,

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the issuer of the exchangeable security does not own the underlying shares. These issuers (typically financial institutions) may be accommodating (through a back-to-back transaction) a shareholder that cannot issue an exchangeable security directly to the public (e.g., because it is not an SEC-reporting company), or may simply perceive a market for the exchangeable security with respect to a particular stock. <sup>[110]</sup>

Underwriters generally view issuances of convertible and exchangeable securities as if there are two parallel offerings, and thus typically seek representations and opinions with respect to both the convertible or exchangeable security and the underlying shares and the related disclosure where both the convertible or exchangeable security and the underlying shares are required to be registered. <sup>[111]</sup> In addition, underwriters will generally seek indemnification with respect to disclosure relating to both the convertible or exchangeable security and the underlying shares. <sup>[112]</sup>

### **[1] Mandatory vs. Optional Conversion or Exchange**

Because of the mandatory conversion or exchange feature, the offer and sale of a mandatorily convertible or exchangeable security is viewed as a simultaneous offer and sale of the underlying shares involving a single "investment decision." <sup>[113]</sup> As a result, there is a single distribution of two securities at the time of issuance of the mandatorily convertible or exchangeable securities. In contrast, in the case of optional convertible or

exchangeable securities there are two distributions, one when the convertible or exchangeable securities are issued and one involving a continuous offering of the underlying shares.

## [2] Registered Offerings of Convertible and Exchangeable Securities

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The issuance of a convertible or exchangeable security is considered by the SEC to involve parallel offerings of the convertible or exchangeable security and the underlying shares, and thus both the security and the underlying shares must either be registered or offered pursuant to an exemption from registration. In most cases, the manner in which the offering of the convertible or exchangeable securities is conducted determines the manner in which the underlying shares are offered and sold pursuant to the embedded option (*i.e.*, both transactions will occur pursuant to a registration statement under the Securities Act, in a resale under Rule 144A, pursuant to a traditional private placement, etc.). With respect to convertible securities, the issuance of the underlying shares usually qualifies under § 3(a)(9) of the Securities Act, which affords an exemption from the registration requirements for the issuance of securities upon the conversion of other securities of the same issuer, <sup>[114]</sup> except where a commission or other remuneration is paid or given for soliciting the conversion.

In the case of exchangeable securities (optional or mandatory), the SEC requires that the prospectus include comprehensive information regarding the issuer of the underlying shares unless the issuer of the underlying shares is not an affiliate of the issuer of the exchangeable securities and either (i) is eligible to offer its securities using Form S-3 or F-3 or (ii) meets all of the listing criteria, both with respect to the issuer and with respect to the securities being issued, that an issuer of the underlying shares would have to meet if the exchangeable security were to be listed on a national securities exchange as an equity-linked security. <sup>[115]</sup> If the issuer of the shares meets either of these criteria, then the exchangeable security prospectus need only include a brief description of the issuer's business, reference to other publicly available information about the issuer filed with the SEC and information concerning market prices of the shares. <sup>[116]</sup> Where the issuer of the underlying shares does not meet either of these criteria, or is an affiliate of the

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issuer of the exchangeable securities, and if the underlying shares are "restricted securities" for purposes of Rule 144, the SEC's disclosure requirements would mandate, in effect, the preparation of two registration statements, one for each of the issuer of the exchangeable securities and the underlying shares, respectively. The cooperation of the issuer of the underlying shares would be required in connection with this process, which is often difficult to obtain absent registration rights or similar contractual obligations. <sup>[117]</sup>

## [3] Private Placements of Convertible and Exchangeable Securities in the United States

Most offerings of convertible and exchangeable securities are structured as private placements pursuant to Rule 144A or traditional private placements under the Securities Act, often, in the case of exchangeable securities, with resale registration rights. <sup>[118]</sup> U.S. investors in these transactions take "restricted securities" subject to limitations on resale in the United States pursuant to Rule 144. <sup>[119]</sup>

In the case of mandatorily convertible and exchangeable securities, the requirements and procedures of a Rule 144A transaction or a traditional private placement only need to be considered and implemented at the time of the initial issuance of the convertible and exchangeable securities, including obtaining any certifications and representations from investors in the form of investor letters. However, the SEC staff has taken the position that, where the underlying security is U.S. exchange-listed or quoted on an automated interdealer quotation system and, thus, fungible under Rule 144A, the transaction does not qualify for Rule 144A (unless the specific underlying shares that will be delivered on exchange, when originally issued, were not U.S. exchange-listed or quoted on an automated interdealer quotation system (so-called "founder's stock") <sup>[120]</sup> or are exempt from

registration because they are not "restricted securities" and can be

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resold in reliance on Rule 144 <sup>[122]</sup> because the purchase of the mandatorily exchangeable security is also the sole investment decision in respect of the underlying shares. The SEC takes this position whether or not the 10% premium test specified in Rule 144A for exchangeable securities is satisfied. The SEC's position would not apply where the mandatory "conversion" or "exchange" can by the terms of the security only be effected by payment of the cash equivalent and not by delivery of the physical securities. <sup>[122]</sup> In addition, the SEC's position relates only to Rule 144A, and most transactions can still be carried out as traditional private placements under § 4(a)(2) with resales under § 4(a)(7) or § 4(1 ½) (although in either case there may be complications because of the unavailability of DTC for clearance and settlement and because compliance will be required with margin regulations). <sup>[122.1]</sup>

For optional convertible and exchangeable securities, the requirements and procedures of a Rule 144A transaction or traditional private placement must be followed both at the time of initial issuance of the convertible or exchangeable security, and at the time the option to convert or exchange is exercised. <sup>[123]</sup> To the extent certifications and representations are obtained from investors in the form of investor letters, these will need to be obtained from each investor at issuance of the convertible or exchangeable securities, and, until the underlying shares become freely transferable pursuant to Rule 144, upon distribution of the underlying shares following conversion or exercise, as well as from subsequent U.S. transferees. However, as a practical matter, because issuance of the underlying shares under convertible securities generally will be exempt under § 3(a)(9) of the Securities Act and thus the holding period of those shares for purposes of Rule 144 will tack to the original issuance of the convertible securities, shares issued on exercise of the conversion option generally will be freely tradable by non-affiliates of the issuer.

Offering participants also need to consider whether the issuer of the convertible or exchangeable security and/or the issuer of the underlying shares is an "investment company" for purposes of the Investment Company Act. <sup>[124]</sup> The procedures for the private placement of the convertible or exchangeable securities, and the distribution of the underlying shares pursuant to the conversion or

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exchange option in the case of optional convertible and exchangeable securities, may need to include representations from investors and subsequent transferees of their status as "qualified purchasers," to the extent the private placement is structured in reliance on § 3(c)(7) of the Investment Company Act. <sup>[125]</sup>

#### **[4] Offerings of Convertible and Exchangeable Securities in Reliance on Regulation S**

For purposes of offerings of convertible and exchangeable securities outside the United States in reliance on Regulation S, the offerings are generally subject to the same restrictions as offerings of straight debt, except for certain Category 3 offerings. Due to the way in which the category is determined for offerings by foreign issuers and the way in which the length of the distribution compliance period is determined for offerings of convertible and exchangeable securities, this exception will generally only affect offerings of convertible and exchangeable securities by U.S. issuers.

The category for an offering of convertible or exchangeable securities under Regulation S is the more restrictive of the categories for offerings of those securities and of the underlying securities. <sup>[126]</sup> The category of an offering by a foreign issuer will depend on whether there is a substantial U.S. market interest in the kind of securities being offered. <sup>[127]</sup> To determine whether there is a substantial U.S. market interest in the convertible or exchangeable securities of a foreign issuer, market interest must be tested for both the convertible or exchangeable securities and the underlying securities. If substantial U.S. market interest exists in either, there is substantial U.S. market interest in the convertible or exchangeable securities. <sup>[128]</sup> With respect to offerings of

convertible securities by foreign issuers, and offerings of exchangeable securities for underlying securities of foreign issuers, because debt offerings of foreign issuers will fall, at worst, into Category 2, and relatively few equity offerings of foreign issuers will fall into Category 3, offerings of convertible securities by foreign issuers, and

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offerings of exchangeable securities for underlying securities of foreign issuers, will generally not fall into Category 3. <sup>[129]</sup>

To determine the appropriate distribution compliance period, convertible and exchangeable securities are generally treated like the underlying securities. Where, however, the securities are convertible or exchangeable only after any applicable distribution compliance period would have ended if the underlying securities were themselves being offered and sold under the safe harbor of Regulation S, an exception to the general rule allows the distribution compliance period to be determined by reference to the convertible or exchangeable securities themselves. Because there is no distribution compliance period for a Category 1 offering, and the distribution compliance periods for debt and equity offerings that fall into Category 2 are the same, the general rule and the exception to it have significance only in an offering of securities that are convertible or exchangeable into Category 3 equity, and Category 3 is unlikely to apply to the equity of a foreign issuer. As a result of the 1998 amendments to Regulation S, <sup>[130]</sup> all convertible securities offerings by U.S. issuers, and offerings of securities exchangeable into equity securities of U.S. issuers, will fall into Category 3. Moreover, because convertible and exchangeable securities are considered to be equity securities rather than debt securities, <sup>[131]</sup> the full panoply of Category 3 restrictions will apply, and the distribution compliance period will be six months (one year if the issuer is a nonreporting issuer) unless the securities are convertible or exchangeable only after six months (one year if the issuer is a nonreporting issuer), in which case the distribution compliance period will be 40 days. <sup>[132]</sup>

The 1998 amendments applying Category 3 restrictions to convertible securities offerings by U.S. reporting issuers raised concerns because a very high volume of convertible securities are sold by U.S. reporting companies under Rule 144A and Regulation S, constituting a significant proportion of all sales of convertible securities by U.S. reporting companies. <sup>[133]</sup> The concerns arose mainly because convertible securities are customarily held in global form and traded

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through book-entry clearance facilities, such as the Euroclear System, Clearstream or DTC. For this reason, compliance with the certification, agreement, monitoring and stop-transfer requirements of Rules 903(b)(3)(iii)(B)(1), (2) and (4) was impracticable, and solving the problem by altering market practice to provide for the issuance of securities in definitive, registered form would be costly and impose additional settlement risk.

The SEC staff recognized these concerns and accepted that book-entry systems are desirable settlement and trading mechanisms. Accordingly, the staff adopted the following alternative procedures for convertible securities of U.S. reporting issuers that are eligible for resale under Rule 144A and that are held in global certificated form by a depository for a book-entry clearance facility:

- the convertible security must be identified by its CUSIP or other issuer identification number as restricted, so that participants in book-entry clearance facilities and others that trade the securities will have notice that transfers of the securities to U.S. purchasers are restricted and must qualify under an available exemption (absent registration);
- any information provided by the issuer or managing underwriters to publishers of publicly available databases about the terms of any new issuance of convertible securities must include a statement that the securities have not been registered under the Securities Act and are subject to restrictions under Rule 144A and Regulation S ;
- the offering circular must contain representations deemed to be made by purchasers in the offering regarding their non-U.S. status (or other exempt status, such as qualified institutional buyer status under

the Rule 144A exemption from registration), and must contain agreements deemed to be made by purchasers under Regulation S (and, where appropriate, Rule 144A) regarding restrictions on resale and hedging; and

- any certificated securities, including both global securities and any physical, certificated securities issued to holders prior to the expiration of the distribution compliance period, must bear an appropriate restrictive legend. Thereafter, those certificated securities must bear a restrictive legend to the extent required by Rule 144. Any certificated securities that are issued during the distribution compliance period (other than in a transaction subject to Rule 144A) must satisfy all of the requirements of Rule 903(b)(3)(iii)(B)(4), including the legending and certification requirements.

The SEC staff noted, however, that these alternative procedures were available only to the convertible securities themselves and not to any equity securities that are issued upon the conversion of the convertible securities during the distribution compliance period. They also confirmed that debt securities that are

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exchangeable into equity securities of a person other than the issuer would be considered to be convertible securities for purposes of Regulation S, meaning that these same procedures described above could be followed in offerings of securities exchangeable for equity securities of a U.S. reporting issuer. <sup>[134]</sup>

In offerings of optionally exchangeable securities, and in offerings of optionally convertible securities in which the offering of the underlying securities is not exempt under § 3(a)(9), steps will have to be taken to ensure that both the offering of the convertible or exchangeable securities and the offering of the underlying securities represented thereby are made in compliance with Regulation S. The offering of the convertible or exchangeable securities will be subject to the ordinary selling restrictions that apply to straight debt, taking into account the complexities described above associated with determining the appropriate category and distribution compliance period. <sup>[135]</sup> In the case of optionally convertible and exchangeable securities, the issuance of the underlying securities on conversion or exchange will be subject to additional restrictions that will vary depending on the category applicable to the underlying securities. These additional restrictions are based on the requirements of Regulation S with regard to the exercise of warrants. <sup>[136]</sup>

When the underlying securities fall into Category 1, and, in the case of convertible securities, if the § 3(a)(9) exemption is unavailable, holders will only have to certify that they are outside the United States when they exercise their conversion or exchange rights. <sup>[137]</sup> When the underlying securities fall into Category 2 or 3, and, in the case of convertible securities, if the § 3(a)(9) exemption is unavailable, there are three additional requirements. First, the convertible or exchangeable securities must bear a legend stating (i) that the securities and the underlying shares have not been registered under the Securities Act and (ii) that the securities may not be converted or exchanged by or on behalf of U.S. persons unless the securities and the underlying shares are registered or an exemption from registration is available. <sup>[138]</sup> Second, each person converting or exchanging a security must be required either (i) to certify that it is not a U.S.

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person and that the security is not being converted or exchanged on behalf of a U.S. person or (ii) to provide an opinion of counsel that the security and the underlying shares have been registered or that an exemption from registration is available. <sup>[139]</sup> Finally, procedures must be established to ensure that the securities may not be converted or exchanged within the United States and that the underlying shares may not be delivered unlawfully within the United States upon conversion or exchange. <sup>[140]</sup>

## **[5] NYSE Listing Requirements for Exchangeable Securities**

The NYSE has specific requirements in connection with the listing of an exchangeable security that has been publicly offered in the United States. <sup>[141]</sup> It requires that the issuer of the exchangeable security either be a NYSE-listed company (or an affiliate thereof) in good standing or meet the general size and earnings

requirements for listed companies. <sup>[142]</sup> In addition, either (i) the issuer must have a minimum tangible net worth of \$250 million or (ii) the issuer must have a minimum tangible net worth of \$150 million and the total original issue price of the securities, when combined with all other equity-linked securities of the issuer listed on a national securities exchange or otherwise publicly traded in the United States, must not be greater than 25% of the issuer's tangible net worth at the time of issuance. <sup>[143]</sup> The issue of the exchangeable security must involve a distribution of at least one million securities to at least 400 holders (provided that if the securities are traded in \$1,000 denominations there is no minimum public distribution or minimum number of holders), and the exchangeable security offered must have a market value of at least \$4 million and a minimum term of one year. <sup>[144]</sup>

With respect to the shares underlying the exchangeable security, the NYSE requires that the class of such shares: (i) represent a minimum market capitalization of \$3 billion and during the 12 months preceding listing be shown to have had a trading volume of at least 2.5 million shares, (ii) represent a minimum market capitalization of \$1.5 billion and during the 12 months preceding listing be shown to have had a trading volume of at least 10 million shares, or (iii) represent a minimum market capitalization of \$500 million and during the 12 months preceding listing be shown to have had a trading volume of at least 15 million

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shares. The issuer of the underlying shares must be an Exchange Act reporting entity and the shares must be listed on a U.S. national securities exchange or traded through the facilities of a national securities association and subject to last sale reporting. <sup>[145]</sup> In addition, the underlying shares to which the exchangeable security relates may not exceed 5% of the total number of shares outstanding. <sup>[146]</sup>

The NYSE requires (other than for foreign private issuers) <sup>[147]</sup> shareholder approval prior to, among other things, the issuance of securities convertible into or exercisable for common stock, if (1) 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 securities; or (2) the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of

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20% of the number of shares of common stock outstanding before the issuance of such securities. However, shareholder approval will not be required for any issuances of securities convertible into or exercisable for common stock involving: (1) any public offering for cash or (2) any "bona fide private financing," if such financing involves a sale of securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock.

## [6] "Pre-IPO" Convertible and Exchangeable Bonds

"Pre-IPO" convertible and exchangeable bonds (sometimes referred to as "going public" convertible or exchangeable bonds) are debt securities where the underlying shares are not listed at the time the convertible or exchangeable bonds are issued. These instruments are a means of introducing an issuer to the market, helping to build the equity story and momentum ahead of an initial public offering and allowing companies to secure cornerstone investors prior to an initial public offering of their shares. The terms of the convertible or exchangeable bonds are similar to traditional convertible and exchangeable securities in some respects, with the holders having the option to convert or exchange their bonds into the underlying shares upon an initial public offering <sup>[148]</sup> of the underlying shares. <sup>[149]</sup>

Pre-IPO convertible and exchangeable securities may be offered outside the United States pursuant to Regulation S under the Securities Act and in the United States pursuant to Rule 144A or in a traditional private placement. The same legal analysis and issues described above need to be considered with respect to the issuance of the convertible or exchangeable bonds and underlying shares (to the extent the exemption under § 3(a)(9) of the Securities Act is

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unavailable <sup>[150]</sup>); however, pre-IPO convertible and exchangeable bonds also present unique practical and commercial considerations.

The terms of pre-IPO convertible and exchangeable bonds typically include conditions under which the underlying issuer is obligated to commence its public offering and the holders are entitled to request that the issuer commence its public offering, and the terms of the initial public offering itself. The terms of the convertible or exchangeable bonds include incentives for an issuer to conduct its initial public offering, provided certain conditions are met. As an initial incentive, the terms and conditions of the bonds usually include an increase or "step up" in the interest rate on the securities if the underlying issuer does not commence its public offering within a specified time following the issuance of the convertible or exchangeable bonds (typically three years). The holders' right to request that the underlying issuer commence its public offering may also be conditioned upon the satisfaction of certain business performance tests (such as achieving a threshold profit level during its last fiscal year, as measured by earnings before interest, taxes, depreciation and amortization ("EBITDA") or net profit) and meeting certain tests for market conditions based on volatility index measures or a certain number of IPOs of a specified size being completed during the relevant measurement period. If the issuer does not commence the initial public offering during a certain period following a valid request notice from the holders (usually within six to 12 months following the request), the holders may have a put option, with the redemption price of the bonds set at a specified equity return on their investment.

Given that the company is not publicly listed at the time the convertible or exchangeable bonds are issued, special considerations apply in structuring the terms of these instruments. As the underlying shares are not listed or quoted, an initial valuation of the company will need to be made (usually with the assistance of financial advisors and based on feedback from potential investors) and serve as a proxy for the underlying share price in determining the conversion

rate. This initial valuation may be subject to adjustment in the event of corporate actions that may increase or decrease the valuation (similar to anti-dilution adjustments for traditional convertible and exchangeable securities). There are also potential difficulties for the company following receipt of a request from the holders to commence an initial public offering. The business performance tests may be an imperfect measure of market receptivity to the company—for example, EBITDA disregards the company's levels of indebtedness and valuation multiples may be lower than expected. The company may also be in the process of undertaking corporate transactions that may be problematic for the timing of an initial public offering, such as a significant merger, acquisition or reorganization. Finally, market conditions may change following the receipt of the request notice, and the market conditions tests may also be imperfect measures of market stress.

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## Footnotes

105 Different securities firms have marketed economically equivalent securities under various service marks, including Debt Exchangeable for Common Stock ("DECS"), Automatic Common Exchange Securities ("ACES"), Premium Exchangeable Participating Shares ("PEPS"), Provisionally Redeemable Income Debt Exchangeable for Stock ("PRIDES"), Stock Appreciation Income Linked Securities ("SAILS") and Mandatorily Exchangeable Debt Securities ("MEDS").

106 The payout formula customarily gives the holder all of the downside, and much of the upside, of owning the underlying equity. For example, if the underlying stock is trading at \$50 per share, a typical convertible or exchangeable security might provide that at maturity of the security the holder will receive one share of stock if the stock is trading at \$50 or lower at maturity; \$50 worth of stock if the stock is trading between \$50 and \$60; and 5/6 of a share of stock if the stock is trading at \$60 or higher.

Because its value is defined by reference to the future value of another security, a convertible or exchangeable security may be deemed to constitute a combination of a debt security with one or more embedded options or an embedded futures contract with respect to the underlying shares (and, where the

underlying shares are denominated in a foreign currency, a foreign currency forward). Whether the embedded equity derivative is comprised of a combination of "options" or a "futures" contract may depend, in large part, on the specific economic terms of the instrument. See § 12.03[5]. In circumstances where the embedded equity derivative may be deemed to constitute a futures contract, the instrument should be structured in a manner that complies with the exclusion from the Central Excise Act ("CEA"), for qualifying hybrid instruments, CEA § 2(f). See § 12.03[5].

- 107 The interest component of a convertible or exchangeable security generally takes the form of a fixed periodic coupon that typically is substantially higher than the dividend on the underlying stock. As an economic matter, the difference between the coupon on the convertible or exchangeable security and the rate of return on a conventional debt instrument is determined in large part by the net premium value of the options embedded in the payout structure of the convertible or exchangeable security and the anticipated dividend yield on the underlying stock.
- 108 This cash settlement right is important for U.S. federal income tax purposes because it helps to confirm that the sale of the underlying shares, and recognition of any gain on that sale, does not take place until maturity. See IRS Revenue Ruling 2003-7, 2003-1 C.B. 363. Prior to the Commodity Futures Modernization Act of 2000 ("CFMA"), cash settlement could give rise to issues under state gaming or bucket shop laws if the exchangeable security was not listed on a national securities exchange or quoted on Nasdaq. Section 28(a) of the Exchange Act, as amended by the CFMA, now preempts state gaming and bucket shop laws with respect to these securities, whether or not listed.
- 109 For issuers of an exchangeable security that hold substantial stakes in the underlying company, the retention of shareholder rights can be an important advantage of the exchangeable structure, as compared to a current sale, because the exchangeable structure allows the issuer to continue to vote the stock and to exercise control over the management of the underlying company. If the underlying issuer is a U.S. issuer, sale of the underlying shares by a large shareholder may give rise to questions in respect of short sales under § 16 of the Exchange Act. See § 6.04[2].
- 110 Certain categories of investors, such as equity-income mutual funds, may be interested in a certain stock because of its growth potential, but may not be willing to invest in a stock that pays no dividends, or very low dividends. Those investors may be willing to give up some of the potential appreciation in the underlying stock in exchange for a current coupon.

Exchangeable instruments in particular are frequently issued through trust structures, whereby, for example, a statutory business trust publicly offers the exchangeable security and concurrently (i) purchases derivative debt securities (typically Treasury strips) from the market to be used to fulfill the interest obligation of the exchangeable security and (ii) enters into a forward purchase agreement with a selling shareholder for the underlying shares that is secured by a pledge of the shares. These trust issuers are generally required to register with the SEC as investment companies. See §§ 15.02 and 15.03.

- 111 See § 3.02[4].
- 112 See § 3.02[3][4][h], Note 317 and accompanying text.
- 113 See *Shearman & Sterling* (avail. Dec. 21, 1998).
- 114 However, in the case of securities of a finance subsidiary or wholly owned operating subsidiary that are guaranteed by its parent and convertible into the securities of its parent, the issuance of the securities on conversion will be exempt from the registration requirements of the Securities Act under § 3(a)(9). See *Section 3(a)(9) Upstream Guarantees* (avail. Jan. 13, 2010).
- 115 See § 10.06[5].
- 116 See *Morgan Stanley & Co., Inc.* (avail. June 24, 1996); see also *In re PaineWebber GOALS Securities Litigation*, 303 F. Supp. 2d 385 (S.D.N.Y. 2004) (dismissing alleged violation of § 11 of the Securities Act, brought on behalf of purchasers of securities issued by UBS AG linked to WorldCom common stock performance, when the prospectus supplement (i) provided an accurate listing of historical WorldCom stock prices, notwithstanding that such prices had been artificially inflated through another party's fraud, and (ii) specifically disclaimed any representation concerning such stock performance and made no representation



concerning WorldCom, the reliability of its financial statements, the accuracy of its public statements or the utility of its common stock performance as a predictor of future stock performance). The *PaineWebber GOALS* decision suggests that an issuer of equity-linked notes can, for purposes of § 11 of the Securities Act, rely on public disclosure about an unaffiliated underlying issuer without any investigation of such issuer, at least if the equity-linked notes issuer provides appropriate disclaimers about the lack of responsibility for, and makes no representations about, any information regarding the underlying issuer.

117 See § 10.03[1].

118 Resale registration generally is not considered necessary for investors in convertible securities in light of the 2008 amendments to Rule 144 that, *inter alia*, shortened the holding period for restricted securities generally to six months for SEC reporting issuers and to one year for other issuers. In the case of convertible securities, this holding period will begin on issuance of the convertible security (and not at the time of conversion). SEC Release No. 33-8869 (Dec. 6, 2007) (amendments effective commencing 2008). In the case of exchangeable securities, however, because the exchange generally will not be exempt under § 3(a)(9), it will create a new holding period for the common stock received upon exchange.

119 See § 7.03[2].

120 See *Shearman & Sterling* (avail. Dec. 21, 1998).

121 See *Mandatorily Exchangeable Issuer Securities* (avail. Oct. 25, 1999).

122 We understand that this position was orally confirmed in the context of mandatorily exchangeable securities to another law firm by the SEC's Office of International Corporate Finance of the Division of Corporation Finance.

122.1 See § 7.08[1].

123 Traditional private placement procedures, based on Regulation D, generally require restrictive legends to be placed on the underlying shares. These requirements substantially limit the types of investors that can accept delivery of the underlying shares and restrict the U.S. liquidity of the underlying shares in the period following the conversion or exercise date. The underlying shares may, however, be sold freely outside the United States in reliance on Regulation S. See § 10.08[4]. *But see* § 7.02[2].

124 See § 15.02.

125 See § 15.06[1].

126 If the securities are convertible or exchangeable into securities of a guarantor, the category into which the offering falls will depend on the nature of the guarantor and the categories applicable to its debt and the underlying securities, and in certain circumstances on the category applicable to the issuer's debt securities. If the guarantor is the parent of the issuer, the category applicable to offerings of the issuer's debt securities can be disregarded, and the offering will fall into the more restrictive of the categories for the guarantor's debt and the underlying securities. If the guarantor is not the parent of the issuer, the offering will fall into the most restrictive of the categories for offerings of the issuer's debt securities, the guarantor's debt securities and the underlying securities.

127 See § 8.02[1][c].

128 See SEC Release No. 33-6863 (Apr. 24, 1990), 55 Fed. Reg. 18,306, 18,313 (May 2, 1990).

129 *But see* § 8.02[1][c][i], Note 49 and accompanying text, and § 8.02[1][c][ii], Note 57 and accompanying text.

130 SEC Release No. 33-7505 (Feb. 17, 1998). See § 8.02, Note 14 and accompanying text.

131 See the definition of "debt security" in Rule 902(a) and the definition of "equity security" in Rule 405 under the Securities Act.

132 SEC Release No. 33-6863 (Apr. 24, 1990). Moreover, both the convertible or exchangeable securities and the underlying shares will be "restricted securities" within the meaning of Rule 144 under the Securities Act and will retain this status for the applicable Rule 144 holding period notwithstanding resales during this period outside the United States under Regulation S. See the discussion of Rule 905 under the Securities Act in § 8.02[2]; *see also* § 7.03[2].

- 133 In 1997, for example, an estimated \$17 billion of convertible securities were sold by U.S. reporting companies under Rule 144A and Regulation S, constituting approximately 55% of all sales of convertible securities in that year by U.S. reporting companies. See Letter from William P. Rogers, Jr., Cravath, Swaine & Moore, to the SEC, Division of Corporation Finance (Aug. 24, 1998).
- 134 See *Sales of Convertible Securities of U.S. Reporting Companies Under Regulation S* (avail. Aug. 26, 1998).
- 135 In addition, the offering of exchangeable securities and, when § 3(a)(9) does not apply, the offering of convertible securities should be treated as a continuous offering of the underlying securities. This would require that in Category 2 and Category 3 offerings, the distribution compliance period should commence with the completion of the distribution of the exchangeable or convertible securities, rather than on the closing date.
- 136 See SEC Release No. 33-6863 (Apr. 24, 1990). See § 10.02[3][a].
- 137 The purpose of this certification is to ensure that the "offshore transaction" requirement is met; Regulation S does not itself set out the certification requirement for Category 1 offerings. Although the certification is not required by law, as a matter of market practice issuers generally request that it be provided.
- 138 Rule 903(b)(2)(i) or Rule 903(b)(3)(i) under the Securities Act.
- 139 Rule 903(b)(2)(ii) or Rule 903(b)(3)(ii)(A) under the Securities Act.
- 140 Rule 903(b)(3)(iii)(B) under the Securities Act. See § 8.02[1][c][ii], Note 57 and accompanying text for a discussion of the procedures applicable to conversion into underlying securities of foreign issuers substantially all of the trading of which takes place in the United States.
- 141 See NYSE LISTED COMPANY MANUAL § 703.21.
- 142 NYSE LISTED COMPANY MANUAL § 703.21.
- 143 NYSE LISTED COMPANY MANUAL § 703.21.
- 144 NYSE LISTED COMPANY MANUAL § 703.21.
- 145 In addition, if the issuer of the underlying shares is a foreign company and the shares are traded in the U.S. market (including trading through ADRs), either: (i) the NYSE must have in place an effective, comprehensive surveillance sharing agreement with the primary exchange on which the underlying shares are traded, or (ii) the ratio of (a) the combined trading volume of the shares and related securities in the United States and any other market with which the NYSE has in place an effective, comprehensive surveillance information sharing agreement to (b) the worldwide trading volume in such securities is at least 50%, or (iii) during the six-month period preceding the date of listing (a) the combined trading volume of the shares and related securities occurring in the U.S. market is at least 20% of the combined worldwide trading volume in such securities, (b) the average daily trading volume in the U.S. market is 100,000 or more shares and (c) the trading volume for the shares is at least 60,000 per day in the U.S. market on a majority of the trading days during such six-month period.
- 146 If the issuer of the underlying shares is a foreign company, then the shares may not exceed: (i) 2% of the total shares outstanding worldwide, provided that at least 20% of the worldwide trading volume during the six-month period preceding the date of listing is effected in the United States, (ii) 3% of the total worldwide shares outstanding, provided that at least 50% of the worldwide trading volume during the six-month period preceding the date of listing is effected in the United States, or (iii) 5% of the total worldwide shares outstanding, provided that at least 70% of the worldwide trading volume during the six-month period preceding the date of listing is effected in the United States. If less than 20% of the worldwide trading volume in the underlying linked security during the six-month period preceding the date of listing is effected in the United States, the exchangeable security may not be linked to such underlying security. See NYSE LISTED COMPANY MANUAL § 703.21.

If an issuer proposes to issue an exchangeable security that relates to more than the allowable percentages of the underlying security, the NYSE, with the concurrence of the staff of the Division of Trading and Markets of the SEC, will evaluate the maximum percentage that may be issued on a case-by-

case basis. NYSE LISTED COMPANY MANUAL § 703.21.

- 147 NASDAQ Listing Rule 5635(d), NASDAQ MANUAL, requires (again, other than for foreign private issuers) shareholder approval for transactions, other than "public offerings," involving (1) the sale, issuance or potential issuance by an issuer of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value, which, 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, or (2) the sale, issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the common stock.
- 148 This is usually referred to as a "qualifying IPO" or "QPO" in the terms and conditions of the bonds and defined as an offering of the underlying shares by the company, provided that (i) the offering results in a free float of at least a specified percentage of outstanding shares or a specified minimum market capitalization and (ii) the shares are listed on certain specified, international stock exchanges. The first element of the proviso is known as the "liquidity condition," as holders want to ensure sufficient liquidity in the underlying shares at the time of the initial public offering. The threshold free float and market capitalization amounts are usually based on the public float requirements of the exchange on which the company is likely to list its shares. The second element of the proviso ensures that the initial public offering is conducted on a reputable, international stock exchange with a sufficient volume of trading.
- 149 Two general structures have emerged for these transactions: (i) the holders have the right to convert into shares determined as the ratio of the bond principal amount to the initial valuation of the company, or (ii) the holders have the right to convert into shares valued at a discount to the initial public offering price of the shares. The second structure can create a perverse marketing message at the time of the initial public offering, as the convertible bond holders may seek to drive the price down in order to receive more shares. Accordingly, the first structure is more commonly used in these transactions.
- 150 Usually the conversion or exchange of the bonds into the underlying shares will be exempt under § 3(a)(9) of the Securities Act, as pre-IPO convertible or exchangeable bonds are typically issued by the issuer of the underlying shares or a finance subsidiary whose securities are guaranteed by the parent issuer of the underlying shares. See *supra* Note 114 and accompanying text. However, prior to an initial public offering, a company may be organized as a partnership or other form of close corporation the ownership of which is represented by ownership interests that are a proxy for common shares. In such cases, the company may be required to reorganize prior to the initial public offering into a new corporate form in order to issue shares, resulting in a different entity issuing shares in the initial public offering than the entity that issued the convertible or exchangeable bonds. In this case, the exemption under § 3(a)(9) of the Securities Act would be unavailable at the time of conversion or exchange of the bonds into the underlying shares (as most pre-IPO convertible and exchangeable bonds are convertible or exchangeable at the option of the holder) and the conversion or exchange into the underlying shares would need to be pursuant to a transaction registered under the Securities Act or an exemption therefrom.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.07, SHARES IN LIEU OF CASH DIVIDENDS**

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 § 10.07 (11th and 12th Editions 2014-2017)

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When foreign companies allow shareholders the right to receive shares in lieu of cash dividends, they must consider whether that is an offer and sale of their shares requiring Securities Act registration. <sup>[151]</sup> For some years, the SEC staff had made a formalistic distinction in interpreting the Securities Act. If the dividend was declared in shares, with an option to receive cash, then no Securities Act registration of the shares was necessary because there was no offer or sale of a security. However, if the dividend was declared in cash, with an option to purchase shares, an offer and sale was deemed to be involved because an investment decision was to be made, and, thus, the shares would have to be registered. <sup>[152]</sup> Most foreign companies previously declared dividends in cash with a share option, and usually excluded U.S. holders from the share option to avoid the cost of registration. Some companies allowed institutional shareholders to exercise the option to acquire shares where counsel is able to advise that the sale was exempt from registration under the Securities Act, because, for example, it qualified as a private placement.

A number of foreign companies have obtained no-action letters confirming that registration is not required where the right of a shareholder to receive a share dividend arises simultaneously with the shareholder's right to receive a cash

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payment. <sup>[153]</sup> Importantly, the staff stressed in each case that, in reaching its no-action position, it had noted that the dividend as declared would provide the alternative of payment in cash or shares, at the election of the shareholder. <sup>[154]</sup> While it is unclear whether these letters should be taken to indicate that the staff has changed its view on the applicability of the Securities Act registration requirement to share dividends in general, the letters do reveal how market practice has evolved in this area and provide guidance to companies in structuring their dividends.

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### **Footnotes**

151 The applicability of the Securities Act's registration requirements to share dividends is also raised when a parent company "spins off" a subsidiary by distributing its shares to parent company shareholders. Although such transactions do not appear to involve investment decisions that would trigger registration requirements, the SEC staff has traditionally taken a contrary view, at least unless certain conditions are satisfied. See SEC, Division of Corporation Finance, Staff Legal Bulletin No. 4 (CF) (Sept. 16, 1997), Fed. Sec. L. Rep. (CCH) ¶60,004, ("Staff Legal Bulletin No. 4") for a discussion of the staff's view. See § 10.09.

152 SEC Release No. 33-929 (July 29, 1936).

153 See, e.g., *British Telecommunications plc* (avail. Oct. 13, 1999); *Greencore Group plc* (avail. July 3, 1996); *Medeva PLC* (avail. Jan. 31, 1995); *TNT Limited* (avail. Apr. 21, 1994); *Barclays de Zoete Wedd* (avail. Mar. 26, 1993); *Albert Fisher Group PLC* (avail. Apr. 9, 1991). In connection with any dividend program, it will be necessary to consider the impact of state securities laws, although recent federal legislation has greatly reduced the significance of such state laws. See generally § 2.04[8]. Certain states may view the option to receive a share dividend as an offer of the shares. Absent registration under state law or qualification for an exemption, shareholders in such states would need to be precluded from making an election between shares and cash, and would be entitled only to receive a cash dividend.

154 See *also* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question 103.01 (Nov. 26, 2008)

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.08, OFFERINGS OF SECURITIES TO EMPLOYEES**

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 § 10.08 (11th and 12th Editions 2014-2017)

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Foreign companies wishing to allow their U.S. employees <sup>[155]</sup> to participate in employee stock purchase plans or to otherwise offer securities to employees must ensure that those plans and other offerings comply with the requirements of the U.S. securities laws. In many cases, registration under the Securities Act and compliance with the reporting requirements of the Exchange Act would be required. As a result, foreign companies often structure employee stock purchase plans for U.S. employees to avoid such registration and reporting requirements. <sup>[156]</sup>

### **[1] Securities Act Considerations**

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#### **[a] Initial Offerings**

As with any offering of securities in the United States, an offering of securities to U.S. employees of a foreign company must either be registered under the Securities Act or be exempt from registration. A foreign company may choose to register the shares being offered to its employees on a Form F-1 or Form F-3, but, unless the employee offering is part of a larger public offering of shares in the United States, such a course may well be impracticable. For companies that are already subject to the reporting requirements of the Exchange Act, one practical alternative to registration on such Forms is to use a Form S-8, the short-form registration statement available for certain offerings of securities to employees. Under Form S-8, the issuer is required to provide each plan participant with information about both the plan and the issuer, but almost all issuer information may be incorporated by reference from Exchange Act filings and the prospectus is not required to be filed with the SEC. <sup>[157]</sup> However, Form S-8 is not available to companies that are not subject to the periodic reporting requirements of the Exchange Act. <sup>[158]</sup>

There are several exemptions from registration under the Securities Act available for employee stock offerings. Rule 701 under the Securities Act expressly exempts offers and sales of securities "under a written compensatory benefit plan." <sup>[159]</sup> The requirements of the rule are minimal: offerings must be pursuant to a written plan, <sup>[160]</sup> the securities must form part of the employees' compensation <sup>[161]</sup> and plan participants must receive a copy of the plan. <sup>[162]</sup> Rule 701 is not available to companies required to file periodic reports under the Exchange Act. <sup>[163]</sup> The main drawbacks of Rule 701 relate to the amount of securities that can be sold. The aggregate sales price and amount of securities sold by an issuer in any consecutive 12-month period cannot exceed the greatest of \$1 million, 15% of the issuer's total assets (or, in the case of a wholly owned subsidiary, its parent's assets, if the securities represent obligations that the parent fully and unconditionally guarantees), or 15% of the total number of outstanding shares of the class being offered and sold in reliance on Rule 701. <sup>[164]</sup> In addition, if sales of securities made in reliance on Rule 701 exceed \$5 million during any consecutive 12-month period, Rule 701 requires additional disclosure to plan participants, including a summary of the material terms of the plan, a summary of risk factors associated with an investment in the securities being sold and financial statements (unaudited, unless the issuer prepares audited financial statements), which must be as of a date no more than 180 days before the sale of the securities. Most importantly, if sales exceed \$5 million in any consecutive 12-month period, foreign companies are required to provide a reconciliation of their financial

statements to U.S. GAAP if their financial statements are not otherwise prepared in accordance with U.S. GAAP or IFRS as issued by the IASB. <sup>[165]</sup>

Foreign issuers may also be able to offer securities to their U.S. employees by means of a private placement pursuant to § 4(a)(2) of the Securities Act or the "safe harbor" of Rule 506 of Regulation D thereunder. <sup>[166]</sup> Such an offering

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must be made only to proper private placement investors, <sup>[167]</sup> but there is no limit on the amount of securities that may be offered.

Regulation D under the Securities Act provides two additional possible "safe harbors" for offers and sales to employees—Rules 504 and 505. The first, which is available only to companies that are not subject to the reporting requirements of the Exchange Act, allows offers of up to \$1 million in any 12-month consecutive period in the United States. The second permits securities to be acquired by up to 35 purchasers <sup>[168]</sup> and allows offers of up to \$5 million in any 12-month period. <sup>[169]</sup> The narrow scope of these limitations means the two rules may be of limited utility to issuers wishing to include their U.S. employees in employee stock purchase plans. <sup>[170]</sup>

## **[b] Resale Restrictions**

Securities offered pursuant to § 4(a)(2), Regulation D (other than pursuant to Rule 504, in certain circumstances) or Rule 701 are "restricted securities," meaning they cannot be freely resold in the secondary market in the United

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States. Securities acquired by employees pursuant to a plan that may not be deemed to involve any offer or sale to the employees ( e.g., a bonus plan) and thus not requiring registration are also required by the SEC to be treated as restricted securities. Generally, restricted securities may be resold in the United States only pursuant to Rule 144 under the Securities Act or in a private placement.

One important way in which the burden of the resale restrictions may be alleviated is the safe harbor permitting resale of securities outside the United States pursuant to Regulation S. <sup>[171]</sup> This safe harbor may be particularly useful for U.S. employees of foreign companies, since the primary market for the shares is likely to be outside the United States.

Resales may also be permitted if they satisfy the so-called "three-prong test." Under that test, which relates only to resales by nonaffiliate employees of securities acquired pursuant to bonus or similar employee benefit plans that do not involve a sale to the employee by the issuer, securities may be freely sold if the following three conditions are met:

- the issuer is subject to the periodic reporting requirements of the Exchange Act,
- the stock is actively traded on an open market (either within or outside the United States), and
- the number of shares being sold is relatively small in relation to the number of shares of that class outstanding. <sup>[172]</sup>

## **[2] Exchange Act and Sarbanes-Oxley Act Considerations**

A foreign company will become subject to the continuing reporting requirements of the Exchange Act, and to the Sarbanes-Oxley Act, if it makes a registered public offering (to employees or otherwise) in the United States. <sup>[173]</sup>

## **[3] State Securities Laws Considerations**

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In addition to complying with the federal securities laws, a foreign issuer offering securities to its U.S. employees must consider the securities laws of the various states where its U.S. employees are located, although federal legislation has greatly reduced the significance of such state laws in the case of companies that file reports under the Exchange Act.<sup>[174]</sup> However, notably, the State of California does not recognize the "no sale" theory referred to above.

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#### Footnotes

- 155 In determining what it means to be a "United States employee," consideration should be given to employees who are not U.S. nationals but who are in the U.S. on temporary assignment. The SEC has noted "[w]hether an employee is on 'temporary assignment' is a matter of facts and circumstances ... [i]t depends on the nature of the assignment, the understanding between the employee and employer, and indicia that the employee will return to the home country. A written agreement helps establish the understanding regarding the nature of the assignment." See American Bar Association: Technical Session Between the SEC Staff and the Joint Committee on Employee Benefits—Questions and Answers, May 6, 2008, available at [http://www.americanbar.org/content/dam/aba/migrated/2011\\_build/employee\\_benefits/sec\\_2008.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/2011_build/employee_benefits/sec_2008.authcheckdam.pdf).
- 156 See, e.g., *Compass Group plc* (avail. May 13, 1999) and *Guinness plc* (avail. Apr. 9, 1993) in which U.K. "share saving schemes" were redesigned for U.S. employees in order to fit under a "no sale" theory for purposes of registration under the Securities Act. The structure approved in *Guinness plc* and *Compass Group plc* has, however, been complicated from a practical perspective by the informational requirements imposed under the PATRIOT Act for opening up bank accounts to large numbers of employees. See § 14.07[4][d] and [f] for a discussion of similar requirements under the PATRIOT Act in connection with the opening of accounts with SEC-registered broker-dealers.
- 157 Form S-8, Part I.  
A well-known seasoned issuer can also use an automatic shelf registration statement to offer securities to its employees pursuant to Rule 415(a)(1)(ii), which allows the registrant to offer securities on a delayed or continuous basis as part of an employee benefit plan. Nonetheless, a well-known seasoned issuer would still need to comply with the informational, filing and other requirements of Form S-3 or F-3, whereas Form S-8 allows the issuer to omit certain information and benefit from special rules not applicable to Form S-3 or F-3. For example, an undertaking to include updated financial statements is required in a registration statement on Form F-3 but not on Form S-8.
- 158 Historically, some shell companies have abused Form S-8 by registering sales of securities to purported employees who actually have not rendered any services to the companies, which in turn has resulted in unregistered resales of those securities into the public market. In order to prevent such abuses, in July 2005 the SEC adopted rules prohibiting shell companies from using Form S-8. Under these rules, a former shell company ( e.g., a shell company that has acquired substantial assets and operations through a business combination) may use the form, but only 60 days after (i) it has ceased to be a shell company and (ii) it has filed with the SEC so-called "Form 10 information"— i.e., the information that would be required by Form 10, Form 10-SB or Form 20-F, as applicable, to register each class of securities to be registered on the Form S-8. The rules except from these 60-day waiting requirements (though not the Form 10 information requirement) shell companies formed in order to effect certain business combinations and change of domicile transactions. The prohibition on the use of Form S-8 by shell companies does not prevent them from registering offers and sales of securities, where permitted, on other forms (shell companies are similarly prohibited from using Forms S-3 and F-3) or from carrying out private placements. See SEC Release No. 33-8587 (July 15, 2005).
- 159 Rule 701(c) under the Securities Act.
- 160 Rule 701(c) under the Securities Act.
- 161 Rule 701(c) under the Securities Act and Preliminary Note 5 to Rule 701 under the Securities Act. This



requirement means that issuers cannot use Rule 701 for an offering designed to raise capital.

- 162 Rule 701(e) under the Securities Act.
- 163 Rule 701(b)(1) under the Securities Act.
- 164 Rule 701(d) under the Securities Act. In determining compliance with these limitations, sales during the relevant 12-month period in reliance on another exemption from the registration requirements of the Securities Act are not integrated with sales in reliance on the Rule 701 exemption. Accordingly, sales in reliance on exemptions such as Regulation D or Regulation S are not required to be taken into account in calculating compliance with the maximum sale limits under Rule 701. Also, while Rule 701 limits the amount of securities that can be sold, Rule 701 does not limit the amount of securities that can be offered to employees. However, securities subject to employee stock options must be treated as having been sold to employees on the date of grant of the options, regardless of exercisability.
- 165 Rule 701(e) under the Securities Act.
- 166 See generally § 7.02[1] and [2].
- 167 In 2005, the SEC brought a settled action against a company and its general counsel on the grounds that an offering to employees was not a valid private placement. See *In the matter of Google, Inc.*, SEC Release No. 33-8523 (Jan. 13, 2005).
- 168 For purposes of Rule 505, the term "purchaser" excludes, among others, natural persons with a net worth (alone or together with their spouse) at the time of purchase in excess of \$1 million and natural persons with an individual income of more than \$200,000 (or joint income with their spouse of more than \$300,000) in the previous two years and a reasonable expectation of achieving the same income in the current year. See Rule 501(a) and (e) under the Securities Act. For this purpose, the SEC staff has said that W-2 income can be used as the measure of income for U.S. taxpayer employees. See "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings: A Small Entity Guide," available at <https://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm>. Rule 506(b) under the Securities Act provides another possible exemption, subject to the requirement that each purchaser who is not an "accredited investor" meet certain business and financial sophistication standards. In the context of employees, the term "accredited investor" includes persons who meet the net worth on income criteria noted above, or who are executive officers of the issuer of the securities being sold.
- 169 To see whether the limit has been reached, the amount of any offering under Rule 504 or Rule 505 must be aggregated with the amount of other securities offered pursuant to exemptions promulgated under § 3(b) of the Securities Act other than Rule 701. See Rule 701(d)(3)(iv) under the Securities Act.
- 170 The SEC staff has indicated that deferrals by employees of the receipt of compensation pursuant to deferred compensation plans could be treated as "sales" of debt securities to such employees by the employer/issuer. In that case, unless an exemption were available, such "sales" would need to be registered under the Securities Act. The same exemptions that are available with respect to employee stock purchase plans would presumably be available with respect to these "sales" of debt securities. See SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects (Nov. 14, 2000). The staff has not provided definitive guidance as to this issue, and practices among companies vary.
- 171 Rule 904 under the Securities Act. See §§ 7.03[2] and 8.02[2]. Rule 904 may not be used by officers and directors who are affiliates of the issuer for reasons other than because they hold such positions (e.g., officers and directors who are also controlling shareholders). In such cases, however, Rule 903 under the Securities Act may be available for sales outside the United States. See §§ 7.03[2] and 8.02[1].
- 172 SEC Release No. 33-6188 (Feb. 1, 1980). The SEC has stated that there will always be a "relatively small" amount of shares involved if no more than 1% of the outstanding securities of the class is distributed by the plan in any one year. SEC Release No. 33-6281 (Jan. 15, 1981). The three-prong test would not permit affiliates of the issuer, which generally includes officers and directors, to resell freely; such persons would still be subject to the restrictions in Rule 144 under the Securities Act applicable to shares held by affiliates that are not "restricted securities."

173 See § 4.02[2].

174 See § 3.02[8].

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.09, SPIN-OFFS, SPLIT-OFFS, EQUITY CARVE-OUTS AND TRACKING STOCK**

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 § 10.09 (11th and 12th Editions 2014-2017)

11th and 12th Editions

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Spin-offs, split-offs, equity carve-outs and tracking stock are mechanisms by which a company can separate a subsidiary or line of business. These separation mechanisms allow companies to unlock value in a well-performing line of business, provide acquisition currency and tie management and employee incentives and compensation more directly to performance, among other advantages. While the mechanics and structure of spin-offs, split-offs, equity carve-outs and tracking stock may differ, each of these options can be employed to accomplish similar objectives.

### **[1] Spin-Offs**

A "spin-off" is a mechanism by which a company (the "*parent company*") separates a line of business by distributing all shares in the separated business (the "*spun-off company*") to parent company shareholders. <sup>[175]</sup> Spin-offs can allow a previously unnoticed, well-performing division of the parent company an

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opportunity to garner higher valuations than the parent or, conversely, separate an underperforming and/or non-synergistic line of business in order to refocus and improve overall market performance of the parent company. They help companies to optimize their capital structures and shareholder distribution policies and to tailor their risk and growth profiles according to investor preferences. Spin-offs also help companies to improve their management alignment—the separation of a line of business can improve the effectiveness of equity-based compensation by more directly tying equity compensation awards to the performance of the business in which employees and executives are most involved. Finally, spin-offs can facilitate the acquisition by the spun-off company of another business, by creating attractive acquisition currency, or prepare a spun-off company for purchase by a third party, by creating a separate and attractive takeover target.

Spin-offs can often be effectuated with minimal to no tax costs for the parent company and its shareholders. To effectuate a spin-off, a parent company distributes all of the stock of an already existing or newly created subsidiary to shareholders on a *pro rata* basis in the form of a dividend, which will generally be eligible for tax-free treatment to the parent company and its shareholders if certain statutory conditions are met. Shareholder composition of the parent company does not change and shareholders of the parent company, as a result of the dividend, own shares in two separate, stand-alone corporations—the parent company and the former subsidiary that was spun off.

When considering a spin-off, the parent company must take many potentially complicating factors into account, including its ability, based on applicable corporate law, to declare a dividend, <sup>[176]</sup> and the extent to which there are third-party agreements that otherwise restrict corporate restructuring and/or dividends. <sup>[177]</sup> Shareholder approval may also be required. <sup>[178]</sup>

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Another threshold question for a parent company that is a foreign private issuer is whether the spun-off company, if also a foreign private issuer, will become an SEC-reporting company. This, in turn, will depend on

whether the parent company itself is an SEC-reporting company. If so, the spun-off company is likely to be required to become an SEC-reporting company as well. If, however, the parent company is not SEC-reporting, the spun-off company likely will not be required to become one either. <sup>[178.1]</sup>

Pursuant to SEC staff guidance, spin-offs are generally exempt from registration under the Securities Act. <sup>[179]</sup> Subject to the above discussion for foreign private issuers, spun-off companies will be required to register under the Exchange Act. <sup>[180]</sup> Under the Exchange Act, domestic companies must file a Form 10 while foreign issuers may file a Form 20-F. Both forms require substantial IPO-style disclosure about the spun-off business <sup>[181]</sup> and are subject to SEC review.

## [2] Split-Offs

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A "split-off" is a mechanism by which a company (the "parent company") separates a line of business by offering shares in the separated business (the "split-off company") to parent company shareholders in exchange for shares in the parent company. <sup>[182]</sup> By offering shareholders a choice of whether or not to exchange parent company shares, split-offs allow investors to express a preference for different types of companies and thus avoid the selloff of unwanted shares that can sometimes follow a spin-off. Like spin-offs, split-offs offer the opportunity to separate businesses that are over- or under-performing. They similarly help companies to optimize their capital structures, tailor their risk and growth profiles according to investor preferences, improve their management alignment and create acquisition currency. However, split-offs are much less typical than spin-offs because they are mechanically more complex and thus more difficult to execute.

To effect a split-off, a parent company, as noted above, makes an offer to its existing shareholders to exchange stock in the parent company for all or a portion of the stock of the split-off company. This structure reduces the number of outstanding shares of a parent company and gives shareholders the ability to choose whether they want shares in the split-off company. After the exchange, the parent company and the split-off company have distinct sets of public owners.

Like spun-off companies, split-off companies are stand-alone public companies and thus are subject to all of the same stock exchange independence and SEC reporting requirements. Unlike spin-offs, however, the split-off process requires registration under the Securities Act because the exchange offer constitutes a sale of the split-off company's stock to investors for consideration consisting of shares of the parent company. Companies must register the exchange offer using Form S-4, or Form F-4 for foreign issuers. Forms S-4 and F-4 require substantial IPO-style disclosure about the split-off company <sup>[183]</sup> but, assuming the parent company is eligible for short-form registration, rely on incorporation by reference of Exchange Act reports for the parent company. They each are subject to SEC review.

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Split-off companies must also register under the Exchange Act, but they may take advantage of short-form registration by filing a Form 8-A <sup>[184]</sup> rather than a Form 10. The exchange offer in a split-off typically constitutes a tender offer by the parent company for its own shares as well, and therefore it is subject to the tender offer rules. <sup>[185]</sup>

## [3] Equity Carve-Outs

An equity carve-out is a transaction in which a parent company sells a minority interest in one of its subsidiaries in an initial public offering ("IPO"). <sup>[186]</sup> Equity carve-outs often precede a spin-off or a split-off and, in such cases, provide a basis on which to determine the market value of the business that will later be spun or split off from the parent. Unlike spin-offs and split-offs, however, equity carve-outs raise capital. They can improve the balance sheets of the parent company and the subsidiary, highlight the subsidiary's value as a separate entity (and in so doing, potentially increase the parent company's value), provide acquisition currency, allow

companies to tie management and employee incentives more directly to performance and allow the parent company and the subsidiary to share resources going forward while accommodating different capital needs. To effectuate an equity carve-out, a parent company sells (or causes its subsidiary to sell) shares of the subsidiary to the public in a public offering. After the offering, the carved-out subsidiary is owned by the parent company and by new public shareholders. Commercial and tax considerations will play a role in

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determining the appropriate stake to offer to the public, but the parent company typically retains a significant interest in the carved-out subsidiary for tax and accounting purposes—for U.S. companies, usually 80% or higher to permit continued tax consolidation.

Under the Securities Act, equity carve-outs must be registered like any other IPO, using Form S-1, or Form F-1 for foreign issuers. Forms S-1 and F-1 require substantial disclosure about the carved-out subsidiary and are subject to SEC review. <sup>[187]</sup> The carved-out subsidiary may utilize short-form registration under the Exchange Act by filing a Form 8-A.

Like a spun-off or split-off company, the carved-out subsidiary is a public company <sup>[188]</sup> that becomes subject to periodic reporting requirements and stock exchange listing rules. In contrast to a spun-off or split-off company, however, the carved-out subsidiary generally will remain under the control of the parent company. As a result, the carved-out subsidiary will not be subject to stock exchange independence requirements, though it will still be required to have an independent audit committee. <sup>[189]</sup>

While the carved-out subsidiary will have a separate board and management team, the parent company typically controls the board, and so will need to be mindful of protections for the new minority shareholders. In some cases, it is advisable to set up a special committee of disinterested directors to approve certain transactions, such as dividends and related party transactions. Additionally, some decisions and transactions—such as material transactions between the parent and subsidiary when there are overlapping directors—will likely be subject to higher levels of scrutiny in the event of any litigation. <sup>[190]</sup> Overlapping directors and the parent company (as the controlling shareholder) must also take care

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not to appropriate business opportunities that rightfully belong to the carved-out subsidiary. <sup>[191]</sup>

## [4] Tracking Stock

Tracking stock is a separate class of stock, generally common stock (but in the case of some foreign issuers a class of preferred stock), issued by a company (the "*issuing company*") to provide an equity return based on the financial performance of a particular subsidiary, division or group of assets of the company (the "*business*"). The issuance of tracking stock allows the financial markets to assign a separate valuation to the tracked business based on its individual financial performance, independent of the other businesses of the issuing company. A company that issues tracking stock typically has a business segment that is expected to grow more quickly, or otherwise receive a higher valuation, than the company as a whole, and the company issues the tracking stock to "unlock the value" of the tracked business in the belief that the total valuation of the tracking stock and the issuing company stock together will be higher than the existing issuing company stock in the absence of the tracking stock. <sup>[192]</sup> Tracking stock can be a valuable acquisition currency and may be used for stock-based management compensation programs. Tracking stock is particularly useful where a divestiture is not practical or desirable (e.g., in the absence of sufficiently developed operations to be a fully-fledged spun-off company) and has attracted renewed interest

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recently as activists and institutional investors continue to push conglomerates to engage in spin-offs. The issuance of tracking stock can also provide significant tax advantages compared to other capital raising

structures, such as a carve-out or sale of the tracked business. <sup>[193]</sup> In addition, it permits the company and the tracked business to preserve operating synergies and administrative efficiencies and retain the same management and board of directors. <sup>[194]</sup>

Holders of tracking stock generally do not have a specific equity interest in the assets of the tracked business, but rather they share with the common stockholders an interest in the aggregate assets of the issuing company, including those of the tracked business. However, upon liquidation of the issuing company, the liquidation proceeds are generally distributed to holders of the tracking stock and of the issuing company's common stock in proportion to the relative market values of such stock during a specified period prior to liquidation. In addition, the issuing company may agree, when creating the tracking stock, to redeem it or to pay dividends in the event of a sale or other disposition of all or substantially all of the assets of the tracked business. Thus, tracking stock permits its holders to hold what is in substance an economic interest in the tracked business without actually owning an interest in the assets of such business (except as part of the aggregate assets of the issuing company).

Organizational documents creating tracking stock may permit it to be redeemed in certain circumstances at the option of the company's board of directors, either in exchange for shares of the company's common stock (often at a

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premium) or in exchange for the stock of a subsidiary that holds all of the assets and liabilities of the tracked business. <sup>[195]</sup>

Tracking stock can have different, including limited or nonexistent, dividend and voting rights. Voting rights of tracking stock can range from a fraction of the vote attributable to a share of common stock of the issuing company (which is intended to approximate the value of the tracked business relative to the company as a whole and may float with changes in market valuation) to having complete voting parity with issuing company common stock. Dividend rights structures also vary, with some companies linking tracking stock dividends exclusively to the segregated pool of revenues from the tracked business, others allocating dividend rights according to fixed ratios and still others providing for no dividends at all. Dividends may typically only be declared out of the profits or surplus of the issuer as a whole, and cannot be paid to the shareholders of a profitable tracked business if there are insufficient retained earnings or surplus for the issuer itself.

A public offering of tracking stock in the United States requires the issuing company, as issuer, to file a registration statement with the SEC. The registration statement must contain (or incorporate by reference) all of the business and financial information required to be included in the applicable form with respect to the issuing company. <sup>[196]</sup> In addition, the registration statement must include separate disclosure of business and financial information specific to the tracked business, including a separate MD&A section relating to the tracked business, risk factors relating to both the tracked business and the tracking stock and consolidated historical financial statements of the tracked business. <sup>[197]</sup> Tracking

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stock is generally listed and publicly traded, trades separately from the issuer's common stock, and has its own ticker symbol.

The issuance of tracking stock does not create separate ongoing reporting requirements for the tracked business under the Exchange Act. However, segment disclosure requirements applicable to U.S. issuers and foreign private issuers will result in the inclusion of segment information with respect to the tracked business in the issuer's annual reports on Form 10-K and Form 20-F, as the case may be. <sup>[198]</sup> In addition, an issuer may elect to provide additional information to the market regarding its tracked business. <sup>[199]</sup>

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## Footnotes

175 Examples of spin-offs include Brookfield Asset Management Inc.'s spin-off of Brookfield Business Partners,

Brookfield Business Partners L.P., Form F-1 (Oct. 27, 2015) ( *as amended*); Darden Restaurants, Inc.'s spin-off of Four Corners Property Trust, Four Corners Property Trust, Inc., Form 10 (Aug. 11, 2015) ( *as amended*); eBay Inc.'s spin-off of PayPal, PayPal Holdings, Inc., Form 10 (Feb. 25, 2015) ( *as amended*); Ingersoll-Rand's spin-off of Allegion, Allegion plc, Form 10 (June 17, 2013) ( *as amended*); Abbott Laboratories' spin-off of AbbVie, AbbVie Inc., Form 10 (June 4, 2012) ( *as amended*); ITT's simultaneous spin-off of Exelis and Xylem, ITT WCO, Inc., Form 10 (July 11, 2011) ( *as amended*) and ITT DCO, Inc., Form 10 (July 11, 2011) ( *as amended*); Marathon Oil Corporation's spin-off of Marathon Petroleum Corporation, Marathon Petroleum Corporation, Form 10 (Jan. 25, 2011) ( *as amended*); Motorola's spin-off of Motorola Mobility Holdings, Motorola SpinCo Holdings Corporation, Form 10 (July 1, 2010) ( *as amended*); IAC/InterActiveCorp's simultaneous spin-off of TicketMaster, HSN, Tree.com and Interval Leisure Group, TicketMaster Entertainment LLC, Form 10 (May 13, 2008) ( *as amended*), HSN, Inc., Form 10 (May 13, 2008) ( *as amended*), Tree.com, Inc., Form 10 (May 13, 2008) and Interval Leisure Group, Inc., Form 10 (May 13, 2008) ( *as amended*); and American Express' spin-off of Ameriprise, Ameriprise Financial, Inc., Form 10 (June 7, 2005).

176 Corporate laws generally require that most dividends be paid out of surplus or earnings. A dividend usually cannot be paid if the payment would render the parent company insolvent.

177 Such agreements may include loan agreements or indentures with restrictive covenants or change of control provisions, and anti-dilution adjustments in convertible debt.

A spin-off also requires consideration of such factors as the interconnectedness of the parent and the spun-off company pre- and post-separation; the organization and disentanglement of shared services, shared contracts, intellectual property, employee benefits and liabilities; internal process decisions such as whether members of the parent company board will serve on the board of the spun-off company; and the corporate governance and administrative duties that come along with the formation of new publicly traded companies.

178 Foreign issuers should look to home-country laws to assess whether they must obtain shareholder approval for a spin-off transaction. In the United States, state law determines whether companies must seek shareholder approval for a spin-off (and, consequently, shareholder approval requirements vary from jurisdiction to jurisdiction). Under the law of most jurisdictions, a shareholder vote is required for the sale or other disposition of all or substantially all of a company's assets. In Delaware, spin-off transactions have not traditionally been viewed as requiring stockholder approval since they do not constitute a sale, lease or exchange of assets but rather a dividend of stock. However, in other jurisdictions such as New York, statutes governing sales or transfers potentially apply to spin-offs and must be given careful consideration. DEL. CODE A NN. tit. 8, §§ 173 and 271; N.Y. BUS. CORP. LAW § 909.

178.1 See Staff Legal Bulletin, No. 4 and Rule 12g3-2(b) under the Exchange Act.

179 Staff Legal Bulletin No. 4 provides that a company does not have to register a spin-off under the Securities Act if it meets the following criteria: (1) the parent shareholders do not provide consideration for the spun-off shares; (2) the spin-off is pro-rata to the parent shareholders; (3) the parent provides adequate information about the spin-off and the subsidiary to its shareholders and to the trading markets; (4) the parent has a valid business purpose for the spin-off; and (5) if the parent spins-off "restricted securities," it has held those securities for at least two years. SEC, Division of Corporation Finance, Staff Legal Bulletin No. 4 (Sept. 16, 1997), Fed. Sec. L. Rep. (CCH) ¶60,004. We note that the SEC staff did not, after Rule 144 was amended to reduce the holding period requirements for "restricted securities" to a one-year maximum, amend Staff Legal Bulletin No. 4 to revise prong (5) above accordingly. We also are not aware of any SEC staff guidance permitting issuers to rely on Staff Legal Bulletin No. 4 in cases where they have held "restricted securities" for one year instead of two. We believe, however, that a one-year holding period requirement is consistent with the tenets of Rule 144 and issuers may want to consider seeking SEC staff guidance if they wish to rely on a one-year holding period rather than a two-year holding period and comply with Staff Legal Bulletin No. 4.

180 Staff Legal Bulletin No. 4 requires that the spun-off company be registered under the Exchange Act, although it permits foreign private issuers to seek no-action relief if they do not intend to register the spun-

off shares under the Exchange Act.

- 181 Both Form 10 and Form 20-F require substantial disclosure of financial data, including audited year-end financial statements (generally balance sheet information for the past two years and income statement, cash flow statement and shareholder equity information for the past three years), interim financial statements (current year quarter(s) and corresponding prior year periods) and five years of selected financial data. Although emerging growth companies are subject to less burdensome financial reporting requirements for Securities Act registration statements for their initial public offerings, that relief is not available for Form 10 or Form 20-F filings used for Exchange Act registration. See SEC, Division of Corporation Finance, Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act, Question 48 (Sept. 28, 2012).
- 182 Examples of split-offs include General Electric Company's split-off of Synchrony Financial, Synchrony Financial, Form S-4 (Oct. 19, 2015) (*as amended*); CBS Corp.'s split-off of its stake in CBS Outdoor Americas, CBS Outdoor Americas Inc., Form S-4 (June 11, 2014) (*as amended*), MetLife's split-off of its stake in Reinsurance Group of America, Reinsurance Group of America, Incorporated, Form S-4 (Aug. 6, 2008) (*as amended*) and Viacom's split-off of Blockbuster, Blockbuster Inc., Form S-4 (June 18, 2004) (*as amended*).
- 183 Like Forms 10 and 20-F, Forms S-4 and F-4 require extensive financial information. See *supra* Note 181.
- 184 Form 8-A may be used by domestic or foreign issuers that (i) are currently registered under the Exchange Act and are subject to the periodic reporting requirements, (ii) are in the process of concurrently registering securities under the Securities Act (as is the case in a split-off) or (iii) have securities listed on a national securities exchange like NYSE or NASDAQ.
- 185 The Williams Act (incorporated as an amendment to the Exchange Act in 1968) generally regulates tender offers. Rule 13e-4 under the Exchange Act more specifically regulates "issuer tender offers"—tender offers for any class of equity security made by the issuer of that class of security or by an affiliate of the issuer. In the event of a split-off, issuers must comply with all procedural, filing and disclosure requirements of both the relevant sections of the Williams Act and Rule 13e-4. Namely, the issuer must file a Schedule TO (tender offer statement), which requires disclosure of the material terms of the transaction as well as the filing of the offer to purchase, letter of transmittal and certain other materials. Rule 13e-4 also requires that the tender offer must be open to all holders of the class of stock and that the consideration paid to any shareholder is the highest consideration paid to any other shareholder. Rule 13e-4(f)(8).
- 186 Examples of equity carve-outs include the Royal Bank of Scotland's carve-out of Citizens Financial Group, Citizens Financial Group Inc., Form S-1 (May 12, 2014) (*as amended*), Santander's carve-out of Santander Consumer USA, Santander Consumer USA Holdings Inc., Form S-1 (Aug. 14, 2014) (*as amended*), Sunoco's carve-out of SunCoke Energy, SunCoke Energy, Inc., Form S-1 (Mar. 23, 2011) (*as amended*) and Morgan Stanley's carve-out of MSCI, MSCI Inc., Form S-1 (July 31, 2007) (*as amended*).
- 187 Like Forms 10 and 20-F, Forms S-1 and F-1 require extensive financial information. See *supra* Note 181.
- 188 The discussion in the text assumes the equity carve-out will be conducted as an initial public offering. It is possible, however, for it to be conducted as a Rule 144A offering (or other private placement) of subsidiary shares in the United States, together with an offering of those shares outside the United States under Regulation S.
- 189 NYSE and NASDAQ listing standards both contain a "controlled company" exemption from board and most board committee standards. Under NYSE and NASDAQ rules, a "controlled company" is a company where 50% of the voting power for the election of its directors is held by a single person, entity or group. A controlled company may choose not to comply with some or all of the governance rules that require a board to be comprised of a majority of independent directors and that require the establishment of a nominating/corporate governance committee and a compensation committee (and require such committees to be comprised entirely of independent directors). Controlled companies are still required to comply with other NYSE and NASDAQ listing standards, including the requirement for a fully independent audit committee. NYSE LISTED COMPANY MANUAL § 303A.00; NASDAQ Listing Rule 5615(c), NASDAQ MANUAL.



- 190 In most business scenarios, when a business decision is made by a board of directors of a U.S. company, courts will evaluate such decisions using the "business judgment rule," a generally permissive standard. When conflicts of interest exist, such as a situation where directors have a stake in both sides of a transaction, the decisions made by those directors may not be protected under the permissive "business judgment rule" standard but rather the higher "entire fairness" standard, which requires directors to establish both the procedural fairness ( *i.e.*, the fairness of the process that resulted in approval of the conflict transaction) and the substantive fairness of the transaction. Given the inherent risk of overlapping roles in carve-out situations, carve-outs can be uniquely exposed to being subject to the "entire fairness" standard. See Christopher E. Austin & David I. Gottlieb, *Renouncing Corporate Opportunities in Spin-offs, Carve-Out IPOs and Private Equity Investments*, 17 INSIGHTS No. 12 (Dec. 2003).
- 191 There is no bright-line test for determining which opportunities belong to a carved-out subsidiary and which belong to the parent company, but under the "corporate opportunity" doctrine, courts might consider a number of factors, including the financial ability to undertake the opportunity, relationship of the opportunity to the line of business and expectations around the opportunity. See Austin and Gottlieb, *supra* Note 190.
- 192 Recent examples include tracking stock issued in connection with the reclassification of Liberty Media Corporation's common stock into three new tracking stocks, Liberty Media Corporation, Form S-4 (Dec. 22, 2015) ( *as amended*); Dell Inc.'s acquisition of EMC Corporation, Denali Holding Inc., Form S-4 (Dec. 14, 2015) ( *as amended*); Fidelity National Financial Inc.'s recapitalization of its common stock into two new tracking stock groups, Fidelity National Financial, Inc., Form S-4 (Apr. 1, 2014) ( *as amended*). Depending on the terms of the issuing company's organizational documents, the issuance of the new class of tracking stock may require the consent of the existing shareholders. It may be possible, where a company is authorized to issue "blank check" preferred stock with terms fixed by the board of directors, to avoid a shareholder vote by using a specially designated class of preferred stock as the tracking stock.
- 193 The issuance of tracking stock generally will not be a taxable transaction for the issuing company (provided that the tracking stock is treated as stock of the parent company and not the actual or constructive subsidiary owning the tracked business), while the secondary sale of shares of a subsidiary would generally result in taxable gains for the issuing company.
- 194 A potential pitfall of the tracking stock structure is the conflicting fiduciary duties of directors that may arise with respect to the common stock and the tracking stock, *e.g.*, with respect to allocation of capital, management and business opportunities, payment of dividends and the conduct and terms of intragroup transactions. See *In re Staples, Inc. Shareholders Litigation*, 792 A.2d 934 (Del. Ch. 2001); *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *General Motors Class H Shareholders Litigation*, 734 A.2d 611 (Del. Ch. 1999); Jeffrey J. Hass, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 MICH. L. REV. 2089 (1996). An issuer should also be aware that its common stock would be deemed a "reference security" of the tracking stock under Regulation M. Thus, the issuer would be prohibited from trading in its tracking stock and its common stock during the restricted period surrounding any distribution of tracking stock. Finally, financial impacts resulting from the operations of one business that affect the company's overall financial condition may affect the market price of a tracking stock for another business. If one of the company's businesses is insolvent, the tracking stock of a different and better-performing division is not necessarily insulated, as assets and income attributed to a tracked business are typically available to all of the issuer's creditors. Similarly, losses in a tracked business can affect the credit rating of the company as a whole and may have adverse secondary effects on the market price of the remaining stock.
- 195 The SEC has taken the position that an exchange of shares of a tracked business (a subsidiary of the issuing company) for outstanding tracking stock relating to such business ( *i.e.*, an exchange offer of the stock of the tracked business to holders of tracking stock) may constitute an "offer," "offer to sell," "offer for sale" or "sale" of the new subsidiary shares within the meaning of § 2(a)(3) of the Securities Act and therefore must be registered or exempt from registration. *Liberty Media Corp.* (avail. Feb. 7, 2001); see also SEC, Division of Corporation Finance, Staff Legal Bulletin No. 4, *supra* Note 179 for the SEC staff's interpretation of the Securities Act registration requirements relating to spin-offs. The exchange of tracking

stock for common stock of the issuing company should be exempt from registration under § 3(a)(9) of the Securities Act where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange. However, the exchange of tracking stock for the stock of the tracked business issued by a subsidiary of the issuing company will likely not be exempt under § 3(a)(9) because the shares being exchanged are not of the same issuer. See *supra* Note 114 and accompanying text.

- 196 See § 3.02[1][b]. Note that an "initial public offering" of tracking stock may be made by a seasoned issuer eligible for Form S-3 (or F-3 in the case of foreign issuers) rather than the Form S-1 (or F-1 in the case of foreign issuers) typically required for an initial public offering.
- 197 In addition to the consolidated financial statements of the tracked business and the issuing company (including the tracked business), some issuers have included a third set of financial statements for the issuing company excluding the tracked business. See, e.g., Ziff-Davis Inc.—ZDNet, Prospectus (Mar. 30, 1999).
- 198 However, the SEC discourages the inclusion in annual reports of anything more than condensed financial information of the tracked business because of the potential to confuse investors about the nature of the tracking stock. For the same reason, the SEC has urged issuers to avoid presenting business disclosure about the tracked business as if distinct from the issuing company. If, despite the SEC's recommendations, complete financial statements of the tracked business are furnished to investors, they must always be accompanied by financial statements of the issuing company. See SEC, Division of Corporation Finance, Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.D (Mar. 31, 2001).
- 199 For example, Alcatel agreed to provide to its ADR depository in the United States annual and quarterly reports in English for its tracked business. Alcatel, Prospectus (Oct. 20, 2000) at 136.

## **U.S. Regulation of the International Securities and Derivatives Markets, § 10.10, CONTINGENT VALUE RIGHTS**

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 § 10.10 (11th and 12th Editions 2014-2017)

11th and 12th Editions

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### **[1] Overview**

Contingent value rights, or ("CVRs"), are contractual rights that entitle the holder to payments when specified contingencies occur. Although CVRs were used in a number of high-profile transactions in the 1980s and 1990s <sup>[200]</sup>, in recent years they have been relatively rare <sup>[201]</sup>. This is likely due to the relatively complex nature of CVRs, as well as difficulties in valuing them and potential ongoing obligations arising out of the issuance of certain types of CVRs. However, CVRs are highly customizable instruments and can be used for a variety of purposes, most notably to bridge valuation gaps in mergers and acquisitions or restructurings. They can also help an acquiror finance an acquisition by reducing the consideration required at closing.

To ensure that CVR holders' rights are adequately represented, CVR agreements typically appoint a trustee, rights agent or other representative on behalf

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of the CVR holders; the powers and obligations of such trustee or representative depend on whether the CVR agreement must be qualified under the Trust Indenture Act (the "TIA"). <sup>[202]</sup>

There are two principal types of CVRs; price-protection CVRs and event-driven CVRs. Some key features of each type of CVR are discussed below.

### **[2] Price-Protection CVRs**

In an acquisition where publicly traded securities (normally, the acquiror's stock) make up all or part of the consideration, price-protection CVRs may be used to "protect" the value of that consideration as target stockholders receive additional consideration in cash or stock if the acquiror's stock (the "reference security") is below a specified target price on agreed-upon measurement dates. <sup>[203]</sup> The target price can be set above or below the pre-announcement trading price of the reference securities. The acquiror may negotiate a floor price that caps the payout obligation of the acquiror under the CVR if the value of the reference securities drops below the floor. A cap on the number of shares payable under the CVR achieves the same purpose when the CVR consideration takes the form of stock. The acquiror may also negotiate redemption rights or early termination rights. Price-protection CVRs typically are in effect for one to three years, but may include an extension right that would typically increase the target price and floor price. Finally, price protection CVRs may include certain acquiror covenants <sup>[204]</sup> and events of default <sup>[205]</sup> designed to protect the holders.

### **[3] Event-Driven CVRs**

Event-driven CVRs are more commonly used in acquisitions than price-protection CVRs. <sup>[206]</sup> They provide additional consideration to the target

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stockholders upon the occurrence of specified contingencies. Such CVRs may be tied to the financial performance of the target generally, but more typically are tied to the performance of particular products of the

target. They are most popular in life sciences/pharmaceutical transactions, where the concept of milestones is already broadly used in licensing agreements and where the success or failure of one product can drastically affect the value of a target company.

Event-driven CVRs can help acquirors and targets reach a deal when there are different views as to, for example, the value of the target's pipeline products, future financial performance, pending litigation <sup>[207]</sup> and outstanding regulatory approvals. Such CVRs will contain one or multiple payment triggers; common examples are FDA approvals or minimum sales of a particular drug. The duration of event-driven CVRs depends on the nature of the trigger(s) and how soon after closing the contingency is expected to be resolved. CVRs that are tied to approvals or financial performance usually use multi-year periods. Payment amounts are determined *via* an agreed-upon formula and may be a simple set amount, or may be variable. Finally, obligations may be imposed on the acquiror post-acquisition in order to align acquiror and target stockholder incentives. For example, if the CVR provides for payouts tied to regulatory approvals or other product-based milestones, the acquiror is often required to take certain measures to achieve such milestones (e.g. using commercially reasonable efforts or "diligent" efforts to continue development of a particular product) <sup>[208]</sup>.

#### [4] Securities Act Registration of CVRs

CVRs, even if payable in cash, may have to be registered under the Securities Act if they constitute a "security" under § 2(a)(1) of the Securities Act. In a series of no-action letters, notably *Minnesota Mining* (avail. Oct. 13, 1988) <sup>[209]</sup>, the SEC staff indicated that the following five factors are required to conclude that a CVR is not a security (i) the CVRs are an integral part of the consideration in the merger; (ii) the holders of the CVRs have no rights common to stockholders (such as voting and dividend rights); (iii) the CVRs are non-interest bearing;

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(iv) the CVRs are not assignable or transferable except by operation of law, and (v) the CVRs are not represented by any form of certificate or instrument. <sup>[210]</sup> If the CVR issuance must be registered, it (and in the case of a stock-settled CVR, the underlying shares) can normally be registered on the same form as any other acquiror securities issued in the transaction (on a Form S-4 or Form F-4).

#### [5] Exchange Act Considerations

The issuance of CVRs that are securities may give rise to registration and reporting obligations under the Exchange Act, for example where the CVRs are listed on a national securities exchange (§ 12(b)), or if the CVR constitutes an "equity security" as defined in § 3(a)(11) and the § 12(g) size thresholds are crossed. If an Exchange Act registration is required, it is usually done on a Form 8-A, incorporating information from the registration statement that was used to register the CVR issuance under the Securities Act.

CVR issuers should consider whether additional disclosure is needed in their periodic reporting under the Exchange Act. For example, if a CVR is linked to the settlement of a lawsuit, the issuer should consider whether to include ongoing disclosure of developments concerning that litigation even if it otherwise would not have been disclosed in the issuer's periodic reports.

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#### Footnotes

200 See, e.g., Quintiles Transnational Corporation/Pharmaceutical Marketing Service Inc., Quintiles Transnational Corporation, Form S-4 (Feb. 18, 1999); Viacom Inc./Paramount Communications Inc., Viacom Inc., Form S-4 (June 6, 1994); The Dow Chemical Company/Marion Laboratories Inc. (1989).

201 Recent examples of deals involving CVRs include Teva Pharmaceutical Industries Ltd./NuPathe Inc., NuPathe Inc., Schedule TO (Jan. 23, 2014) (*as amended*); Forest Laboratories, Inc./Clinical Data, Inc., Clinical Data, Inc., Schedule TO (Mar. 8, 2011) (*as amended*); and Sanofi-Aventis SA/Genzyme Corp., Genzyme Corporation, Schedule TO (Oct. 4, 2010) (*as amended*).

- 202 Qualification under the TIA is required in connection with certain debt securities; thus, the parties must make a determination as to whether the CVRs constitute debt securities. See § 3.05[4].
- 203 See, e.g., Viacom Inc./Paramount Communications Inc., Viacom Inc., Form S-4 (June 6, 1994) and Viacom Inc./Blockbuster Entertainment Corp., Viacom Inc., Form S-4 (Aug. 29, 1994).
- 204 Such covenants may require the acquiror to reserve sufficient shares to satisfy the CVR obligations, or to use commercially reasonable efforts to list the CVRs. The acquiror and its affiliates may also be restricted from share repurchases, and the acquiror may be subject to further obligations if it engages in extraordinary transactions or certain dilutive transactions such as stock dividends or stock splits. Tailored covenants for particular deals may also be used.
- 205 Such events of default may include failure to make payments, certain bankruptcy and insolvency events, or other breaches of the CVR agreement.
- 206 See, e.g., Valeant Pharmaceuticals/Synergetics USA, Inc., Synergetics USA, Inc., Schedule TO (Sept. 16, 2015) (*as amended*); Zeneca, Inc./Omthera Pharmaceuticals, Inc., Omthera Pharmaceuticals, Inc., Form 8-K (May 28, 2013); Sanofi-Aventis/Genzyme, Genzyme Corporation, Schedule TO (Oct. 4, 2010) (*as amended*); Celgene/Abraxis, Celgene Corporation, Form S-4 (July 29, 2010) (*as amended*); Fresenius Kabi Pharmaceuticals Holding/APP Pharmaceuticals, Fresenius Kabi Pharmaceuticals Holding LLC, Form S-4 (Aug. 1, 2008) (*as amended*).
- 207 For an example of a litigation-driven CVR, see Community Health Systems, Inc./Health Management Associates, Inc., Community Health Systems, Inc., Form S-4 (Sept. 25, 2013). Information Resources, Inc. Litigation Contingent Payment Rights Trust was formed to allow CVR holders to receive certain of the litigation proceeds under the CVR agreement. Information Resources, Inc., Schedule TO (July 14, 2003) (*as amended*) and Information Resources, Inc. Litigation Contingent Payment Rights Trust, Form S-4 (Sept. 8, 2003) (*as amended*).
- 208 See, e.g., ViroPharma Incorporated/Lev Pharmaceuticals, Inc., ViroPharma Inc., Form S-4 (Aug. 19, 2008) (*as amended*); Indevus Pharmaceuticals, Inc./Valera Pharmaceuticals, Inc., Indevus Pharmaceuticals, Inc., Form S-4 (Jan. 29, 2007) (*as amended*).
- 209 *Minnesota Mining and Manufacturing Company* (avail. Oct. 13, 1988).
- 210 No-action letters have also suggested other factors that may help the conclusion that the CVR is not a security, but these factors have not been as commonly cited nor consistently applied: (i) the right is not dependent on the operating results of any party involved; (ii) almost all of the holders of the rights will continue with the surviving corporation as employees; (iii) the value of the payments resulting from the rights is a small fraction of the overall consideration. See, e.g., *Genentech Clinic Partners III* (avail. Apr. 28, 1989) and *Northwestern Mutual Life Insurance Co.* (avail. Mar. 3, 1983).